198615

HARKINS CUNNINGHAM
ATTORNEYS AT LAW
SUITE 600
801 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20004-2615
202 973-7600
FACSIMILE 202 973-7610

WRITER'S DIRECT DIAL
(202) 973-7601

2800 ONE COMMERCE SQUARE
2005 MARKET STREET
PHILADELPHIA, PA 19103-7042
215 851-6700
FACSIMILE 215 851-6710

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May 15, 2000

Mr. Vernon A. Williams, Secretary
Surface Transportation Board
Office of the Secretary
Case Control Unit
Attn: STB Ex Parte No. 582 (Sub-No.1)
1925 K Street, N.W.
Washington, DC 20423-0001

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Re: **Major Rail Consolidation Procedures (STB Ex Parte No. 582 (Sub-No. 1))**

Dear Mr. Williams:

Enclosed for filing in the above-referenced proceeding are an original and 25 copies of the Comments of Canadian National Railway Company (including the attached Statement of Christopher A. Vellturo, Ph.D.). In accordance with the Board's notice served March 31, 2000, in this proceeding, all pages of this filing, including this cover letter, are paginated consecutively.

Also enclosed is a diskette containing the text of this filing in WordPerfect 6/7/8/9 format.

Very truly yours,

Paul A. Cunningham /jmg

Paul A. Cunningham

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Enclosures

BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES - ADVANCE NOTICE OF PROPOSED RULEMAKING

COMMENTS OF CANADIAN NATIONAL RAILWAY COMPANY

Jean Pierre Ouellet
CANADIAN NATIONAL RAILWAY COMPANY
P. O. Box 8100
Montreal, PQ H3B 2M9
(514) 399-5430

Paul A. Cunningham
Richard B. Herzog
HARKINS CUNNINGHAM
801 Pennsylvania Avenue, N.W., Suite 600
Washington, D.C. 20004-2664
(202) 973-7600

Attorneys for Canadian National Railway Company

May 16, 2000

TABLE OF CONTENTS

BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES – ADVANCE NOTICE OF PROPOSED RULEMAKING

COMMENTS OF CANADIAN NATIONAL RAILWAY COMPANY

Canadian National Railway Company, Grand Trunk Western Railroad Incorporated, and Illinois Central Railroad Company (collectively, "CN") hereby file comments in response to the Board's Advance Notice of Proposed Rulemaking, Major Rail Consolidation Procedures, served March 31, 2000 ("ANPR"). CN comments first on the Board's statements concerning its overall policy towards major rail consolidations; then on proposals for ensuring that mergers do not cause service disruptions; and thereafter on the particular topics on which the Board invited comment, in the order in which they appear in the ANPR.[1]

In these comments, CN makes a sharp distinction between subjects that the Board should consider in this ANPR proceeding, and subjects that pose matters of overall industry policy that

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[1] CN will use the term "merger" to refer to any transaction requiring approval under 49 U.S.C. § 11323 involving one or more Class I railroads.

the Board should pursue, if at all, outside of this proceeding. The general industry policy matters include the following: the issues, information and analyses that should be brought to bear on the question whether an industry structure consisting of two East-West U.S. transcontinental railroads would be consistent with the public interest; whether the Board should mandate physical access to bottlenecks or otherwise regulate bottleneck rates; and whether the Board should restructure relationships between shortlines and major railroads. CN proposes that, if the Board wishes to pursue the industry-wide policy matters, it do so in separate proceedings, concurrent with this proceeding and as additional sub-dockets in Ex Parte No. 582, and that the Board conduct those separate proceedings, as this ANPR proceeding should be conducted, over a period of not more than six months.

With respect to matters that properly belong in this proceeding, CN applauds the Board's interest in raising the bar in control proceedings with respect to service, and makes suggestions for achieving that goal. As stated by CN's President and CEO in his statement before the Board in Ex Parte No. 582:

> the public interest has shifted, from concerns about industry failure to ever-increasing demands for improved quality. We should all realize that we have now entered the next stage of railroad development – enhancing service to regain a portion of the transportation market that railroads have lost to other, more service oriented modes. Now is the time to focus the public interest inquiry on whether a transaction will lead to better service in markets that will be affected.

Ex Parte No. 582, Statement of Paul M. Tellier (Feb. 29, 2000) at 3 ("Tellier Statement").

In addition, CN recommends that the Board:

- recognize that rail mergers present continuing opportunities for increasing the efficiency of the North American rail network

- consider initiating immediately, in parallel with this rulemaking and as a sub-docket in Ex Parte No. 582, an expedited informational proceeding with respect to an industry structure consisting of two East-West U.S. transcontinental railroads. The informational proceeding would not be designed to generate rules or guidelines, but to identify the issues, information, and analysis that could be brought to bear if and when the Board is presented with a specific proposal for a merger between a U.S. Western and Eastern railroad

- consider certain direct downstream effects on other existing railroads, for example, to ensure continuation of essential services, but maintain the present "one-case-at-a-time" rule with respect to downstream transactions; in the alternative, maintain the rule but broaden the class of persons (now limited to merger applicants) that can petition for its waiver

- to facilitate mergers that are win/win for all rail constituencies, including rail labor, recognize that the issue of override of collective bargaining agreements should be addressed between labor and management in the context of bargaining; if the Board were to recommend that Congress eliminate statutory override, CN would be favorably disposed to such a recommendation in principle

- continue the Board's proven case-by-case approach to "three-to-two" issues, in order to reflect both the experience with competition in two-railroad markets, and contemporaneous tools of economic analysis

- continue the Board's proven case-by-case approach to issues concerning the merger-relatedness of public benefits, which keeps the door open for merger-opponents wishing to challenge merger applicants on these issues

- recognize that NAFTA establishes a framework for addressing cross-border operations by surface transportation providers in consultation with international trade partners, in light of the evolving integration of the NAFTA economies

- modify the rules in various technical respects as to which waivers are routinely granted in merger proceedings, to bring the rules into alignment with actual needs of the Board for information about transactions presented for approval

In these comments, CN identifies a number of changes that the Board might propose with respect to its general merger policy statement or other provisions of the rules in Part 1180. These are matters that the Board could develop as well or better in the course of individual merger proceedings, and, in fact, most of these issues have been considered by the Board in various merger proceedings since the passage of the Staggers Act. The Board, however, has invited comment on rule changes. CN, accordingly, without in any way departing from its position in pending litigation with the Board concerning the Board's Moratorium Decision in Ex Parte No. 582,[2] goes beyond discussion of policy in these comments to formulate suggestions for amendments to the present Part 1180, if the Board wishes to amend its rules and policy statements rather than proceed as it has in the past through case-by-case adjudication.

If it makes these or any other changes, however, the Board should maintain the present, non-binding, approach of the Merger Policy Guidelines, which the ICC stated when it adopted them: "the policy statement here is a statement of general policy only. Parties will have the opportunity to challenge these policies through appropriate evidence or argument in individual cases." Railroad Consolidation Procedures, General Policy Statement, 363 I.C.C. 784, 790-91 (1981). The economy is so dynamic, and the facts of each proposed transaction are so particular, that it would be unwise for the Board to take any other approach.

I. OVERALL POLICY

Recommendation. The first two sentences of the Board's "General policy statement for merger or control of at least two Class I railroads" state: "The Surface Transportation Board encourages private industry initiative that leads to the rationalization of the nation's rail facilities and reduction of its excess capacity. One means of accomplishing these ends is rail

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[2] Western Coal Traffic League v. STB, Nos. 00-1115, 00-1118 and 00-1120 (Consolidated) (D.C. Cir., petition for review filed March 17, 2000).

consolidation." 49 C.F.R. § 1180.1(a). Properly understood, these sentences accurately reflect Congressional policy. If, however, the Board proceeds to amend its guidelines, it may wish to clarify its approach by changing these sentences to read: "The Surface Transportation Board encourages private industry initiatives that would increase the efficiency of the North American rail network. One means of accomplishing greater efficiencies is rail consolidation."

Two basic principles would further this policy, and CN recommends that the Board be guided by them in its application of the public interest standard. First, the Board will judge rail mergers by their direct effects. Second, the Board will implement policies for the industry as a whole on an industry-wide basis, outside of merger proceedings.

Discussion. The Board has concluded that the goals of its merger policy, which it describes as encouraging railroads to "rationalize excess capacity," have largely been achieved. ANPR at 3. It is not fully apparent what the Board means here by "rationalization." Past mergers have reduced inefficiencies associated with redundant facilities, in some instances by eliminating them, and, in others, by making them productive in new ways (for example, by directional running on parallel track, or by yard specialization). Thus, rationalization has to do with making assets more productive, which may not depend on downsizing assets but on changing how they are used. "System rationalization" is broader than downsizing; is still ongoing and always will be as traffic patterns and technologies change; and is a feature not only of parallel but of end-to-end mergers, which can, for example, bring scale-economies and route optimization, and increased equipment utilization through seasonal complementarities, increased backhaul and triangulation, and reduced cycle times.

CN therefore disagrees with the Board's statement that it "does not appear that there are significant public interest benefits to be realized from further downsizing or rationalizing of rail route systems." Id. It would be wrong to conclude that, because there no longer are opportunities for parallel mergers between Class I railroads, public policy should no longer encourage rail consolidations. Neither competition nor mergers are ends in themselves; the goal of merger policy under the ICCTA, as under the antitrust laws, must always be to encourage efficiency, including the quality of service. It would be a policy and legal error for the Board to link the policy of encouraging rail mergers exclusively to downsizing.

Even in the period immediately following the Staggers Act, the Board recognized that mergers can bring benefits other than downsizing, and that assets can be made more productive through end-to-end mergers, as well as parallel mergers.[3] The continuing opportunities for increasing efficiency can be illustrated, for example, by the continuing increases in the Average Length of Haul ("ALOH"), discussed in the attached statement by Dr. Christopher Vellturo. Ex Parte No. 582 (Sub-No. 1), Statement of Christopher A. Vellturo (May 16, 2000), at 6-7 ("Vellturo Statement").[4] In whatever sense the Board was describing "system rationalization" as

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[3] Railroad Consolidation Procedures, 49 C.F.R. § 1180.1(c)(1): "[C]onsolidation is the only feasible way for rail carriers to enter many new markets. . . ."; Burlington Northern, Inc. – Control & Merger – St. L., 360 I.C.C. 784, 938-44 (1980) (end-to-end); Norfolk So. Corp. – Control – Norfolk & W. Ry., 366 I.C.C. 171, 173, 175, 196-200 (1982) ("NS") (improved routings); CSX Corp. – Control – Chessie and Seaboard C.L.I., 363 I.C.C. 518, 553 (1980) (new single-line services).

[4] Page references herein are to the internal pagination in the Vellturo Statement, which is located at the top of each page; the consecutive pagination is at the bottom of each page.

a goal that has now been largely accomplished, that accomplishment certainly does not mark the end of all opportunities for increasing efficiency.[5] As Dr. Vellturo states, "the potential for significant welfare gains through rail mergers does not appear to have been exhausted. The source of these gains has changed." Id. at 10. Insofar as rail consolidations enhance efficiency, they should be encouraged. Unless and until Congress changes its policy favoring rail mergers, the Board would lack authority to do otherwise.

Moreover, there is, if anything, an additional reason today for a policy encouraging mergers that did not exist when the Board adopted its General policy: because of the evolution of the Board's own merger standards, no major railroad would enter into a merger transaction for the purpose of garnering market power. It is therefore reasonable to presume that mergers are prompted by the incentive to gain efficiencies.

Railroads seek profits; that is their obligation to their shareholders. Mergers can increase profitability in three possible ways: lowering costs, increasing output without a corresponding increase in costs, or increasing market power. Vellturo Statement at 8.[6] In the period since the Board adopted the General policy, the Board has made clear that it will not approve major

[5] "ALOH" is defined as the ratio of total revenue ton-miles of freight to revenue tons of freight. Vellturo Statement at 6 n.4. Between 1979 and 1989, ALOH for Class I railroads increased by 21 percent. The mergers of the 1980s did not exhaust these opportunities, however; from 1989 through 1998, ALOH increased by another 15.5%, and those increases were concentrated at the railroads that underwent consolidations in the 1990s. Id. at 7.

[6] "Market power" is not increased competitive ability; to the contrary, market power is the ability profitably to sustain price increases above competitive levels for a significant period of time. ("Price increase" includes a reduction in quality without a reduction in price.) The exercise of market power entails higher prices and lower output.

mergers that would have substantial unremedied anticompetitive effects, i.e., that would create or increase market power.[7] As a general rule, no major railroad would today propose a merger expecting that it would be allowed to reduce the number of serving railroads from two to one, for example, even if a case could be made that intermodal or geographic competition would provide an effective competitive constraint after the merger. As the Interstate Commerce Commission ("ICC") showed in Santa Fe S. Pac. Corp. – Control – Southern Pac. Transp. Co., 2 I.C.C.2d 709, 715 (1986) ("SF/SP"), if it cannot remedy substantial anticompetitive effects, it will not approve a merger. Because the Board has unambiguously taken market power off the table, it is all the more reasonable to presume that merger proposals are motivated by opportunities for increased efficiency and output. The policy favoring mergers arose prior to a time when this presumption may have been reasonable, so that the presumption is not essential to the policy. Nevertheless, this presumption is now a further reason that supports the policy.

Efficiency gains through mergers relate directly to solving what the Board refers to in the ANPR as "the key problem faced by railroads," which the Board describes as: "how to improve profitability through enhancing the service provided to their customers." Resolution of that problem requires "adding to insufficient infrastructure, not . . . eliminating excess capacity." ANPR at 3. Mergers have an essential role to play in improving "profitability through enhancing

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[7]This is a different approach from the situation that existed when the Board adopted its general policy. The Supreme Court in McLean Trucking Co. v. United States, 321 U.S. 67, 87 (1944), expected that the agency would "estimate the scope and appraise the effects of the curtailment of competition which will result from the proposed consolidation and consider them along with the advantages of improved service, safer operation, lower costs etc." (Emphasis added.)

the service provided to . . . customers." As the Board has long recognized, end-to-end mergers improve service; increase effective capacity without additional investment, through increased asset utilization; and make investments in additional infrastructure economic that would not be economic for a railroad absent the increased volumes resulting from the merger.

The Board's formulation of the "key problem" rightly emphasizes that infrastructure plays an important role in service improvement. For that reason, among others, the Board should not propose guidelines that would make mergers an occasion for access or other bottleneck regulation unrelated to any reductions in competition caused by the merger. Such access in any form would necessarily reduce railroad revenues and, during the transition, create tremendous uncertainty that could increase railroads' costs of capital. It should also be noted, however, that service improvement also requires not only additional infrastructure but the efficient utilization of any given rail network. The latter depends upon management incentives, information, and skills. As CN will discuss below under the heading "Merger-Related Public Interest Benefits," end-to-end mergers can enable managements operating in a common economic interest to achieve service improvements and efficiencies that they would not likely otherwise achieve.

II. SAFEGUARDING RAIL SERVICE

Recommendation. The Board should expect merger proponents to meet higher expectations for quality rail service. If the Board sees a need to reflect this higher expectation in new guidelines, it could be expressed by amending Section 1180.8(a) to add a new sub-paragraph that would read as follows: "A description, designated a 'Service Integration Plan,' of the means by which applicants will implement the transaction without major service disruptions, including at least the following: the management, equipment, and technology resources that applicants will apply to the implementation; plans for handling service at points that are common to the two applicants; plans for handling service with other railroads at specific common points and major interchanges; measurement and publication of overall system performance during the implementation period; a general approach to early detection and recovery from any service problems that may arise, recognizing that solutions to service contingencies cannot be fully developed in advance of the contingency; and any features of the system, such as routing or terminal flexibility, that would be expected to help avoid or mitigate unexpected service problems. For this purpose, the implementation period will generally be considered to be the first 24 months following consummation of the proposed transaction."

The Board might also require applicants to identify the elements of service guarantees that the merged railroad would negotiate with individual shippers.

Discussion. The Board states in the ANPR that, "whether or not a particular proposed consolidation holds promise of significant service enhancing and cost reducing synergies, the integration task is itself quite complex and time consuming, and has, in a number of recent instances, been associated with severe service dislocations." ANPR at 3. The Board requests comment on "how our merger rules might best be revised to protect customers and shortline railroads from merger-related service disruptions and the loss of adequate infrastructure and capacity." Id. at 7.

As noted, CN fully supports the Board's initiative in developing means for better-assuring that merger-implementation does not entail major service disruptions. As Mr. Tellier stated during the Ex Parte No. 582 proceeding, "our customers can be the beneficiaries of a new railroad paradigm that emphasizes responsible growth and responsive customer service." Tellier Statement at 7. Implementation is a part of this paradigm. "Accordingly, we think that it is time to refine the public interest [standard] to respond to shipper concerns about severe post-merger service disruptions." Id. at 19.

If the Board wishes to amend its rules, rather than refine the public interest standard in individual proceedings, CN recommends that the Board propose a guideline that would require merger applicants to submit a Service Integration Plan addressing certain specified matters relating to service during at least the first 24 months following consummation. Experience has shown that, if severe merger-related service disruptions are going to occur, they are most likely to do so during that initial period. The Service Integration Plan should describe the means by which applicants will implement the transaction without major service disruptions, and should address at least the elements described in the amendment to Section 1180.8(a) proposed above.

In addition, CN agrees that the Board, in assessing the financial viability of a proposed merger, should consider the continued ability of the carriers involved "to acquire new or utilize existing infrastructure and capacity." ANPR at 6. As Mr. Tellier stated in the Ex Parte No. 582 proceeding: "Future applicants should . . . be prepared to demonstrate that their cash flows and debt levels will permit them to respond with alacrity to any service problems that require additional financial resources." Tellier Statement at 24. Similarly, the Board should assess whether either railroad proposing to combine is still suffering from any problems associated with earlier consolidations, and whether the proposed transaction "is more like the past consolidations that have yielded efficiencies without service disruptions, or is . . . more like past problematic transactions." Id. at 22.

In its invitation for comments on safeguarding service, the Board notes the question posed by the Secretary of Transportation whether future mergers may create railroads that are "too big to manage, yet too big to fail." ANPR at 7. The suggestion in that connection is that the Board "examine the financial terms carefully with a view toward minimizing future service disruptions and any harm that could result from any such disruptions." As discussed above, CN agrees. CN notes that this inquiry should include the amount of debt involved in the transaction, and its effects on the merged railroad's cost of capital and on the speed with which the merged railroad might be impelled to attempt complete implementation of its transaction.

More generally, Dr. Vellturo points out that underlying the concerns of the type expressed by the Secretary are the "generalized economic notions that (i) these large rail systems will have exhausted scale economies and moved into the decreasing returns to scale portion of the industry cost curve ("too big to manage"); and (ii) these large rail systems present the potential for serious harm to various markets within the U.S. economy if the firms were to face financial disaster ("too big to fail")." Vellturo Statement at 22. As Dr. Vellturo shows, however, and as discussed above in connection with overall rail merger policy, "mergers will continue to afford opportunities for a more efficient network structure," for example through "improved run-through operations and more efficient and more effective long hauls." Id. at 22-23. The Service Integration Plan and service guarantees that CN supports (discussed above) will also provide further assurance that a merged railroad will be efficiently and effectively managed.

The added efficiencies mean that mergers will reduce rather than increase the risk of failure, which becomes particularly important in the face of competition from other modes and from overseas imports. Id. at 22. Mergers will also reduce the risk of failure insofar as they enable "the new railroad systems to diversify their production portfolio, thereby reducing their reliance on a single (or smaller) set of industries." Id. at 23. This added scope can make railroads "better able to survive a significant transitory downturn in a given industry," and may increase their ability "to reconfigure their networks in response to the longer term loss of business due to increased competition through the global economy," or in response to "changing trade patterns that present new opportunities for rail transportation." Id. at 23.

III. DOWNSTREAM EFFECTS

Recommendation. CN has two recommendations regarding "downstream effects."

First, CN believes that consideration of whether an industry structure consisting of two U.S. East-West transcontinental railroads would be consistent with the public interest should ultimately occur in the process of reviewing any individual transactions that give rise to that issue. However, the Board might wish to inform itself now of the issues that are likely to arise in any such proceeding, without prejudging the merits of any individual transaction.

To that end, the Board should consider initiating immediately, in parallel with this rulemaking and as a sub-docket in Ex Parte No. 582, an expedited informational proceeding for the purpose of hearing views and enriching its understanding and that of all railroads and their constituencies with respect to an industry structure consisting of two East-West transcontinental railroads. The proceeding would not be designed to generate rules or guidelines, but would inform all concerned parties of the issues, information, and analysis that could be brought to bear if and when the Board is presented with a specific proposal for a merger between a U.S. Western and Eastern railroad.

Second, with respect to other "downstream effects," CN doubts that there are any downstream effects appropriately considered in a merger proceeding that cannot be identified and handled well under the Board's existing guidelines. Thus, to downstream transactions, the Board should maintain the present rule contained in section 1180.1(g). As with all of Part 1180, this rule may be waived upon petition of an applicant (section 1180.4(f)) or sua sponte by the Board. If it otherwise decides to promulgate new rules, however, the Board may want to clarify this issue by adding a new second sentence to section 1180.4(f)(5) that reads as follows: "The Board will waive section 1180.1(g) on a case-by-case basis only when there are substantial reasons for doing so and the Board has strong reason to believe that the probative value of evidence relating to announced downstream transactions that would result from the pending transaction will outweigh the increased complexity and delay of the control proceeding. The Board will not allow consideration of announced downstream transactions to jeopardize statutory deadlines or the manageability of control proceedings."

Alternatively, the Board could adopt a more permissive approach by amending section 1180.4(f)(1) by adding a new second sentence to read as follows: "Persons other than applicants that state to the Board their intention to participate in a control proceeding and to offer evidence relating to announced downstream transactions that would result from the pending transaction may petition the Board to waive section 1180.1(g)." The Board should then add the second sentence to section 1180.4(f)(5) that is proposed above. Again, CN does not believe that either of these amendments to section 1180.1(g) should be required for the Board to consider whatever it wishes in individual cases.

Discussion. All pro-competitive mergers have "downstream" effects in the nature of dynamic effects on the market. The improved service and greater efficiencies of the merged entity provoke competitive responses by other railroads and other types of carriers.[8] These responses can take the form of new service initiatives, new investments, and new control transactions.

Some of these downstream effects should be considered in control proceedings, and assessment of those effects does not require repeal of the present rule. As stated by CN's President and CEO Paul Tellier: "If a particular transaction poses a structural issue that is a real and immediate consequence of that transaction, then the place to address it . . . is the public interest inquiry that Congress created just for that purpose." Tellier Statement at 5. For example, the Board is required to take downstream effects into account by considering impacts on essential services provided by other existing railroads. To take another example, CN believes that merger applicants should be required to show that their implementation plans will not have adverse operational impacts on other existing railroads. Merger applicants may wish to show

[8]See Union Pac. Corp. – Control – Missouri Pac. Corp., 366 I.C.C. 462, 488 (1982) ("UP/MP") ("Because competition itself benefits the public, the anticipated competitive responses of other carriers to a consolidation are public benefits.").

how reduced congestion at particular terminals as a result of their merger will benefit other existing railroads as well as themselves.[9]

The ANPR, however, raises a different and far broader question: whether the Board should take into account downstream transactions. In this regard, the ANPR responds to concerns expressed in Ex Parte No. 582 with respect to control transactions involving Class I railroads other than the applicants to a particular transaction and that are likely to result from that transaction. The Board seems especially concerned by the prospect of a North American rail structure consisting of two East-West transcontinental railroads ("transcontinental rail duopoly") See ANPR at 4. The remainder of CN's comments in this section will focus on the question of downstream transactions. CN will address the "duopoly" issue first, and then discuss downstream transactions apart from that issue.

The "Duopoly" Issue

The "duopoly" question is a matter of general policy about industry structure, which many believe poses issues outside the merits of any one transaction. CN believes that the merits of a specific proposal for an East-West transcontinental railroad would, in fact, subsume all of the relevant issues, and in a concrete factual setting, and that proposals for inefficient transactions are unlikely to be made in the first place.

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[9]In Canadian Nat.l Ry. Co. – Common Control, STB Finance Docket No. 33842, Decision No. 1A (STB served Dec. 28, 1999) ("Decision 1A"), the Board on its own motion waived § 1180.1(g). Neither CN nor BNSF objected to that decision, and their application will include evidence relating to downstream effects.

Nevertheless, the Board may wish to examine the "duopoly" question outside the boundaries of any one merger proceeding, without, in the end, prejudging the merits of any individual transaction. If the Board wishes to pursue these issues as a matter of general, industry-wide policy, a sound approach would be an expedited informational proceeding for the purpose of hearing views and enriching the understanding of the "duopoly" question by the Board and all railroads and their constituencies. That inquiry would not likely lead to writing rules or guidelines. Instead, it would draw into one forum the best information and analyses that are available in advance of a proposal for a particular East-West transaction.

The Board could, for example, invite comment on the kinds of efficiencies that a transcontinental railroad could bring, the existing or potential demand for such services, the bearing of globalization and international trade, ways of identifying relevant markets for competition analysis, the significance of the vigorous competition in two-railroad markets that exists today, the framework for analyzing possible effects on incentives or ability to exercise market power, labor issues, issues of managerial control, and the risks of failure of one of two systems. All of these are the kinds of issues that the Board has considered in individual merger proceedings. The Board may, however, wish to test in an informational hearing whether there is anything about a two-railroad transcontinental structure that adds fundamentally different dimensions to these issues. With such a record in hand, potential applicants for an East-West transcontinental transaction would evaluate their options and frame any transaction accordingly, and, if such an application were presented, the Board would evaluate the merits in light of the knowledge gained (which might include the knowledge that the Board's longstanding approach to individual mergers remains the proper approach in the transcontinental context). The Board could also evaluate its present rule on downstream effects at the conclusion of the informational proceeding.

Other Downstream Transaction Issues

Outside the context of a proposed merger between a U.S. Western and Eastern railroad, the Board should stay with its present rule that generally bars consideration of downstream transactions, while allowing waiver in particular circumstances (CN's second recommendation). If the Board wishes to widen the opportunity for waiver, it could remove the present limitation of waiver petitions to applicants, and allow any person to seek a waiver who states an intention to participate in a proceeding and offer evidence relating to announced downstream transactions (CN's alternative recommendation). The present rule is sound and, perhaps with the exception of that procedural change, the Board should not change it.

The Board would greatly expand its role in merger review if it were to expand control proceedings to include downstream transactions. As with any expansion of regulation, the Board must ask whether such an expansion is authorized, and whether the benefits of expanded regulation outweigh the costs. CN believes that the benefits will not outweigh the costs as a general matter, and, therefore, it would be inappropriate to adopt a guideline that generally opened control proceedings to evidence relating to downstream transactions. CN further believes that considerations of downstream transactions could lead to decisions that the Board is not authorized to make.

Expanding control proceedings to consider downstream transactions is unlikely as a general rule to yield significant benefits to the regulatory process. Various witnesses in the Ex Parte No. 582 proceeding, including Dr. Vellturo, and Nobel Laureate Kenneth Arrow, pointed out that, if a merger, by ratcheting up competition through improved service and other efficiencies, causes other railroads to merge in order to develop new efficiencies of their own, that is a pro-competitive outcome that the STB should welcome, not resist. Ex Parte No. 582, Statement of Kenneth Arrow (Feb. 28, 2000), at 9-10; Ex Parte No. 582, Statement of Christopher Vellturo (Feb. 29, 2000), at 2, 9-10. For that basic reason alone, it is doubtful that the Board's consideration of downstream transactions would yield evidence that could transform a merger that is otherwise in the public interest into one that is not in the public interest.

It is, therefore, reasonable to ask, what would the Board do with evidence of downstream transactions?

- Is the Board likely ever to decide that an A/B transaction, while consistent with the public interest on its own merits, is not consistent with the public interest because it would lead to a C/D transaction and that second transaction would not be in the public interest but failure to approve that second transaction would lead to a "competitive imbalance" and that "competitive imbalance" would be contrary to the public interest?
  - Would the parties have to litigate the public costs and benefits of the C/D transaction as part of the A/B proceeding?
  - Is it not likely that, if the Board found "competitive imbalance" to be contrary to the public interest, that consideration would itself weigh in the balance in favor of approving the downstream transaction with appropriate conditions?
- Is the Board likely ever to decide that an A/B transaction, while consistent with the public interest on its own merits, would lead to a C/D transaction and would

somehow impose public costs on the C/D transaction that would make it not consistent with the public interest?

- Is the Board likely ever to decide that an A/B transaction, while consistent with the public interest on its own merits, is not consistent with the public interest because an A/C transaction would somehow be "better" or "more" in the public interest?

  - This kind of inquiry would turn control proceedings into comparative proceeding in which the Board would attempt to determine not only whether the pending transaction is consistent with the public interest, but whether it is the best transaction from among all possible permutations. Such a role would be beyond the Board's authority and would be unworkable.

- Would the Board ever decide that, even if the A/B transaction and a responsive C/D transaction were both in the public interest, a third transaction, E/F, or C/D/E, would not be?

- What is the logical boundary; what about a fourth transaction?

Anything is possible. But a situation in which consideration of downstream transactions would change what would otherwise be approval to disapproval under the public interest standard, or what would otherwise be disapproval to approval, surely would be the exception and not the rule. It is highly unlikely that the Board would, in fact, ever reach any of these conclusions in a merger proceeding, if it were to consider downstream transactions. Moreover, some and perhaps all of these determinations would be beyond the Board's authority, as they would be at odds with the fundamental structure of the statute, which requires the Board to approve a transaction that is consistent with the public interest, and which leaves restructuring to the initiative of private industry.[10]

Moreover, taking into account downstream transactions would present intractable problems of analysis and, in the end, would not be susceptible of principled decision making. For example:

- If the Board attempted to weigh the public benefits of a pending transaction against public costs of a downstream transaction, how would it discount for the greater uncertainty of the costs of the downstream transaction?
- If the Board attempted to weigh the public costs of the pending transaction against public benefits of the downstream transaction, how would it discount for the greater uncertainty of the benefits of the downstream transaction?
- If the Board attempted to weigh public costs that the pending transaction would somehow impose on a downstream transaction, how would it discount for the uncertainty concerning the particulars (e.g., the operating plan, traffic diversions, management and financial structure) of the downstream transaction?
- And would the Board not then also be obligated to weigh public costs that the downstream transaction would impose on the pending transaction?

In short, the unlikely potential benefits of considering downstream transactions do not warrant repeal of the present rule.

That conclusion is only strengthened by the fact that the costs of expanding control proceedings to encompass downstream effects would be tremendous. That would be true

[10]The small likelihood that routine consideration of downstream transactions would yield important benefits means that repeal of the present rule would not square with the directives in the Rail Transportation Policy "to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required," and "to provide for the expeditious handling and resolution of all proceedings." 49 U.S.C. §§ 10101(2), (15).

whether the consideration is limited to announced downstream transactions, or extends to transactions that have not been announced. Either would vastly increase the complexity of already complex Board proceedings. Each control proceeding could become a litigation about multiple transactions. Even if the Board could conduct such proceedings within statutory deadlines, the effect would be to impose delay.

For all the controversy that such litigation would generate, the quality of information would often be low. For example, suppose that resolution of the issue with respect to the downstream transaction required information about the operating plan for the downstream transaction. Where would this information come from? If the applicants tried to fashion an operating plan for the announced downstream transaction, that plan could not possibly be the operating plan that the parties to that downstream transaction would develop. Yet, even if the downstream transaction had been announced, the parties to that transaction would often be many months away from developing their own operating plan, and waiting for them would jeopardize statutory deadlines in the pending transaction.

Consideration of downstream transactions would carry additional risks to the public interest because the Board could not know whether the parties to an announced or hinted subsequent transaction, having confounded a pending transaction, would then change their minds and not go forward. In that event, the Board might have denied approval to a transaction that, on its own merits, is in the public interest, because of considerations relating to some future transaction, which then does not occur.[11] Consideration of downstream transactions carries the risk of erroneous denial of the pending transaction. This risk is far greater than the risk of erroneous approval from not considering downstream transactions, as shown by the falling rates and increasing output that has occurred during the period of mergers since the Staggers Act. The risk of erroneous approval is especially diminished by the availability of oversight conditions of the type imposed in recent mergers, which, for example, keep the Board's doors open for evidence of anticompetitive behavior.

The difficulties would be even worse if the Board were to consider hypothetical transactions, rather than announced transactions.[12] In that event, discovery would extend to the

[11]CN proposes that, before the Board considers evidence relating to a downstream transaction, the parties to that transaction be required to demonstrate that it is contingent on consummation of the pending transaction. That requirement, however, does not eliminate the risk described here of erroneous denial, because the Board cannot force parties to the downstream transaction to apply for Board approval or to consummate their transaction if approved.

[12]The scope of the Board's inquiry appears to go beyond the downstream effects that are addressed (and excluded from control proceedings) by the provisions of the present rule. Those relate to announced transactions. As the Board is aware, its present rule was first stated in St. Louis S.W. Ry. – Pur. – Rock Island, 363 I.C.C. 323 (1980), where the issue was whether to reopen the record to take account of the Santa Fe/Southern Pacific transaction, which had been announced during the pendency of that proceeding. The present rule addresses that question ("events can occur during [agency] consideration of a consolidation." Section 1180.1(g) (emphasis added). The agency did not even consider it necessary explicitly to rule out consideration of unannounced transactions, and it is doubtful that anyone had ever advanced the notion of considering unannounced transactions. Nevertheless, the Notice in this proceeding, and the Moratorium Decision, appear to be driven in part by concerns about unannounced transactions. Accordingly, CN discusses reasons why the Board should not consider evidence relating to unannounced transactions.

most sensitive strategic matters. Litigation, including discovery, with respect to unannounced transactions could cause problems at the SEC under the securities laws. The prospect of deposing CEOs of the major railroads about their intentions to enter transactions that they have not yet entered into, and as to which they may not even have yet disclosed their interest to the prospective merger partner, is one that should give pause to any proponent of opening control proceedings to evidence of unannounced downstream transactions.

CN believes that the Board should maintain its present one-case-at-a-time rule. Routine consideration of downstream transactions would bring few, if any, benefits, and would entail tremendous costs. The Board remains free to decide to accept evidence of downstream transactions based on considerations specific to a particular case.

If, however, the Board believes that it should widen the opportunities to present evidence relating to downstream transactions, it should simply expand the class of persons entitled to petition for waiver of the rule, which is now limited to applicants. The Board could amend its waiver provisions (section 1180.4(f)(1)) to provide that persons other than the applicants can petition for waiver of the rule. Such persons would be required in the petition to state their intention to participate in the proceeding and offer evidence relating to downstream transactions.

In no event should the Board entertain evidence of unannounced transactions. The Board should require, at the least, a definitive merger agreement, filed with the SEC, by no later than some early stage of the pending proceeding. Moreover, the Board should limit consideration to downstream transactions that are downstream "effects" -- transactions that the parties to those transactions have shown to be caused by the pending transaction. Thus, the Board should require the definitive merger agreement in the downstream transaction to be contingent on approval of the pending transaction, before it will be considered in the pending proceeding, and the Board should require the parties to that transaction to establish that their transaction is in fact a consequence of the transaction under review, such that they would abandon their transaction if the transaction under review were not consummated for any reason. Parties to the downstream transaction should also have to establish their bona fide intent to present an application to the Board and to consummate their transaction if approved with acceptable conditions, if the pending transaction is consummated.

At the same time, in light of the unlikely benefits and likely costs discussed above, the Board should state explicitly in section 1180.4(f)(5) that it will waive the present rule "only when there are substantial reasons for doing so and the Board has strong reason to believe that the probative value of evidence relating to announced downstream transactions will outweigh the increased complexity and delay of the control proceeding." The guideline should further state that evidence concerning downstream transactions is not a required part of applicants' prima facie case. The parties to downstream transactions or other persons should have the burden of coming forward in the first instance and offering reasons why the downstream transaction means that the transaction under review is not in the public interest. At that stage, the downstream issues would be in play and the parties can develop the record accordingly.

IV. MAINTAINING SAFE OPERATIONS

The ANPR notes that in the recent major rail merger proceedings it has required the applicants to work with FRA to formulate a "Safety Integration Plan" ("SIP"), and that the Board and FRA have already instituted a joint rulemaking to elaborate further the requirements for SIPs. Accordingly, the Board sees "no need to address the SIPs process further in this proceeding" and it intends to "continue to require SIPs on a case-by-case basis, where appropriate, until the SIPs rulemaking proceeding is concluded." ANPR at 6.

CN is committed to the safety of all its operations in the U.S. and Canada. CN also has first-hand experience with the SIP process from the CN/IC proceeding, where it proposed to prepare a SIP before it was required to do so. CN (and BNSF) have already indicated their intention to file a SIP in connection with their application in Finance Docket No. 33842, and had already begun informal consultations with FRA before the Board issued its "moratorium" decision on March 17, 2000, in Ex Parte No. 582.

Based on this experience with the benefits and flexibility of the SIP process, and the fact that a rulemaking on this subject has already gone through several stages, which should put the Board in a good position to act without the need for further proposals or comments, CN agrees with the Board that no further rulemaking proceedings are needed on this subject.

V. PROMOTING AND ENHANCING COMPETITION

Recommendation: Many of the competition issues posed by the ANPR, including mandated physical access and separate regulation of "bottleneck" rates, are industry-wide issues, unrelated to particular transactions. If the Board wishes to consider new guidelines to address these issues, it should begin a separate generic proceeding, parallel and contemporaneous with Ex Parte No. 582 (Sub-No. 1).

Discussion. The Board states in the ANPR that:

> with the industry far more concentrated than it was when our current regulations were fashioned; with the prospect that any further major rail merger would trigger strategic responses that could lead to a transcontinental rail duopoly; and with only limited opportunities remaining for significant merger-related efficiency gains – the time has come for us to consider whether we should revise our rail merger policy . . . with an eye towards affirmatively enhancing, rather than simply preserving, competition.

ANPR at 4.

CN does not believe that the provisional conclusion follows logically from the premises stated by the Board, but that is not the issue here. The proposals advanced by various parties for "enhancing" competition largely involve forced physical access to bottlenecks through trackage rights or switching, or mechanisms that would result in the regulation of bottleneck rates; CN will refer to both as "access."[13] CN does not believe that the Board should or could legally use its conditioning power to increase competition. If the Board believes that the time has come to conduct a general inquiry into whether and when to mandate access, it should open a separate

[13]The ANPR identifies (a) physical access through trackage rights over bottleneck segments, mandated switching within and adjacent to terminal areas, or requiring new through routes at Board-ordered interchange points when the shipper has a contract for the competitive segment beyond that point, and (b) separate contracts for the competitive portion of joint-line routes in order to enable regulation of the rate for the bottleneck segment. ANPR at 7-8. The Board also invites comment on the "one-lump" theory, but does not raise any issue about the analytic soundness of the theory. Instead, the Board asks for comment on whether it should condition mergers on access in situations where the one-lump analysis applies. The arguments against doing so are the same as those relating to access, discussed in the text.

docket for that purpose, and invite comments on the merits of access for the entire industry, outside of the merger context.

CN does recognize that bottleneck rates present a merger-specific issue in one circumstance, where the shipper prior to the merger would have been entitled to regulation of a bottleneck rate under the Board's "contract exception" to the general rule that a carrier that offers single-line service or participates in a joint rate between an origin and destination may not be required to quote a separate rate for the bottleneck segment. By creating a new single-line route, a merger could remove this regulatory option for the shipper. Accordingly, CN would not oppose a Board policy to apply the contract exception post-merger in circumstances where it would have been available pre-merger.

Outside of that one narrow area, a separate inquiry with respect to access is the proper course for at least four reasons. First, the merits of access, which have long been debated, are unrelated to mergers, which the Board does not allow to create bottlenecks. Access issues are industry issues, and should be treated as such.

Second, to use the conditioning power to increase competition would likely exceed the Board's conditioning authority, broad as it is. The Board must approve a merger that is "consistent" with the public interest. The merger need not advance or promote the public interest.[14] A merger that creates no bottlenecks and that is otherwise consistent with the public

[14] St. Louis S.W. Ry. – Purchase – Alton & S. R. R., 342 I.C.C. 498 (1972), 1972 ICC Lexis 2, at *33-34: "The phrase 'consistent with the public interest' means compatible with, or not contradictory or hostile to the public interest. Under Section 5(2), the test is whether the transaction 'will be consistent with the public interest,' and the phrase does not connote a public

interest does not become inconsistent with the public interest in the absence of access. And the Board's authority to impose conditions is bounded by the public interest standard that governs the transaction. Lamoille V. R.R. v. ICC, 711 F. 2d 295, 301 (D.C. Cir. 1983).[15]

Third, to impose access conditions would be an unwise use of the conditioning power, quite apart from the intrinsic arguments for or against access. The ICC stated in the SF/SP decision that it would not use the conditioning authority to undertake "major restructuring" that could have "significant unforeseen consequences." To impose access conditions, however, would entail just that risk. As recently as 1998, in its decision in Review of Rail Access and Competition Issues, STB Ex Parte No. 575 (STB served June 11, 1998), the Board stated that (a) no one had showed how access would permit railroads to "recover sufficient revenues to cover system costs and support reinvestment in the rail facilities that shippers require" and (b) the "shape and condition of the rail system that access would produce" was unresolved; "it is quite possible that open access would produce a smaller rail system . . . that would serve fewer and a different mix of customers . . . ." In other words, in the language of SF/SP, use of the conditioning power to achieve access would entail "major restructuring" that could have "significant unforeseen consequences," not only with respect to revenue adequacy but the very

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benefit to be derived or require the promotion of the public interest. See Merchant's Dispatch, Inc. – Purchase – Smathers, 25 M.C.C. 407, 409; Southern Ry. – Control – Central of Georgia Ry. Co., 317 I.C.C. 557; Chesapeake and O. Ry. Co. – Control – Baltimore & O.R. Co., 317 I.C.C. 261, 285; and Great Northern Pac. – Merger – Great Northern, 331 I.C.C. 228, 247."

[15]Moreover, had Congress intended to allow the STB to condition mergers in order to "promote" competition, it would have so indicated in the ICCTA, but it did not do so.

size, configuration, and service-mix of the national network. Again, those are industry issues to be examined in a separate proceeding.

Fourth, if access were to become a cost of merging (and an opportunity presented by merging if the standard access condition required reciprocity on the part of any railroad using the condition), decisions about mergers would no longer turn on the intrinsic benefits and costs that result from the merger itself. Access would become a separate calculus, which could deter otherwise profitable mergers or cause otherwise unprofitable mergers, with the effect of distorting capital markets and otherwise impairing efficiency. As Dr. Vellturo states: "The imposition of costs unrelated to a proposed combination would distort the incentives of railroads to undertake welfare-enhancing business combinations and thereby reduce welfare absent the regulation." Vellturo Statement at 12.

The Board also invites comment on use of its conditioning power to require merger applicants to maintain open gateways for all major routings. CN has committed in connection with its BNSF proposal to maintaining open gateways. Unlike access, this issue does relate, at least in theory, to possible effects of a merger, in the form of inefficient vertical foreclosure. The ICC and Board dealt with this possibility on a number of occasions, and concluded that merged railroads continue to have strong incentives to use the most efficient routes, including interline routes where the merged railroad's single-line route is less efficient (has higher variable costs).[16]

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[16]Union Pac. Corp. – Control – Chicago and North Western Trans. Co., Finance Docket No. 32133, Decision No. 25, ICC served March 7, 1995, slip op. at 84-85, 87-89, 98; UP/SP, slip op. at 128-29.

There is no evidence that there have been inefficient routings following any of the major end-to-end mergers of the last twenty years. The risk of attempting to fashion a rule to prescribe how merging railroads are to maintain gateways is that there will be effects similar to those that were caused by the ill-fated DT&I conditions, which took away merger efficiencies and forced inefficient routings.[17] In the absence of a demonstrated problem, the Board need not impose prescriptive requirements on merger applicants. Merger applicants should be required to propose some form of commitment to the maintenance of open gateways.

VI. SHORTLINE AND REGIONAL RAILROAD ISSUES

The Board correctly notes in the ANPR that many of the concerns expressed in Ex Parte No. 582 by shortline and regional railroads are subsumed in issues relating to service and competition. ANPR at 8. The ANPR requests additional comment with respect to further suggestions that merger applicants be required to submit plans for "promoting" the viability of

[17]The Commission summarized, in NS, 366 I.C.C., 241, n.97: "Until recently, the Commission had automatically imposed traffic protective conditions known as 'DT&I Conditions.' See Detroit, T. & I. R. Co. Control, 275 I.C.C. 455 (1950), which required a merged system to keep open all preconsolidation routes and channels of trade. These conditions had been construed to require rate equalization between routes impacted by the consolidation .... We recently determined that the DT&I Conditions were inconsistent with a competitive environment and both eliminated such conditions previously imposed and announced that we would not impose them in the future. See Traffic Protective Conditions, 366 I.C.C. 112 (1982) ...." Without disagreeing with the ICC's general conclusions in Traffic Protection Conditions, the Sixth Circuit reversed, on the ground that the ICC "must conduct individual hearings on each previously approved merger before it can find that revocation of DT&I conditions imposed on that merger is appropriate." Detroit, T. & I. R.R. v. United States, 725 F.2d 47, 51 (6th Cir. 1984).

existing regional and shortline railroads, based on the "Bill of Rights" advocated by the American Short Line and Regional Railroad Association. Id.

CN has important relationships with shortline and regional railroads, which provide origination and termination functions that are essential for certain traffic. CN notes that AAR will be entering into negotiations with shortlines concerning possible changes to the Rail Industry Agreement entered into by the Class I railroads and the shortlines in 1998.

As with other issues raised by the ANPR, the Board's merger policies with respect to shortlines should not seek to resolve issues not created by mergers, or to enhance the position of shortlines in comparison with their pre-merger situation. Such issues as "paper barriers," "steel barriers," pricing issues, and equipment supply, are not properly a part of merger policy. CN's proposals for Service Integration Plans and for service guarantees to shippers should largely address shortline concerns that are related to mergers, as these proposals are designed to and will have the effect of reducing the likelihood of merger-related service disruptions. CN's proposals for maintenance of existing significant gateways will also address merger-related shortline concerns.

VII. EMPLOYEE ISSUES

The ANPR invites comment on whether the Board should require merger applicants to forego the statutory override of collective bargaining agreements (so-called "cram-down"), and whether standard New York Dock – Control – Brooklyn E. D. Term., 360 I.C.C. 60 (1979) ("New York Dock") protections should be expanded from the present six years, for example, to ten years. ANPR at 8. (The ANPR also invites comment on other unspecified "concerns" of rail employees; not knowing what these are, CN will wait for the reply comments to address them.)

CN believes as a general matter that rail mergers in the future should be win/win for all rail constituencies -- shippers, labor, and stockholders. CN, accordingly, has agreed to negotiate with each union the solution to the override (so-called "cram-down") of collective bargaining agreements if it merges with BNSF. The Board, however, must adhere to Congressional limits on its authority, and could not itself eliminate statutory override by rule, or condition merger approval on waiver. If the Board were to conclude that statutory override should be eliminated, the proper course would be to convey that recommendation to Congress. CN is favorably disposed to such legislation in principle.

The six-year protection of New York Dock was of course first adopted in that case. It has proven to be generally workable (and provides protections more beneficial to employees than separation packages applied to hourly workers in non-railroad private industry). Any claims that the New York Dock protections should be enhanced are best made and evaluated with respect to a specific transaction. Any other approach would lead to choosing an arbitrary period; there is no generic reason that would justify, for example, ten rather than six years. The Board has augmented New York Dock conditions in particular cases. For example, in the CN/IC decision, the Board augmented those conditions by extending them to employees who choose not to follow their work to Canada. Canadian Nat'l Ry. – Control – Illinois Cent. Corp., STB Finance Docket No. 33556, Decision No. 37, slip op. at 57 (STB served May 25, 1999) ("CN/IC").

VIII. "THREE-TO-TWO" ISSUES

The Board has invited comment on "whether and how our assessment of 'three-to-two' effects should be reflected in our new merger rules, or whether this issue is best left to a case-by-case examination based on the individual circumstances of each case, as it has been in the past." ANPR at 9. This issue should be left to case-by-case determination.

The Board's case-by-case approach to three-to-two issues looks at both actual experience and reasoned prediction based upon economic analysis and logic. In Union Pac. Corp.– Control and Merger – Southern Pac. Rail Corp., Finance Docket No. 32760, Decision No. 44 (STB served Aug. 6, 1996) ("UP/SP"), for example, the Board cited relevant experience to conclude that railroads "can and do compete effectively with each other in two-railroad markets." UP/SP, slip op. at 117. The Board noted the "decreasing rates in two-carrier rail markets under Staggers Act deregulation," and the vigorous competition between BNSF and UP in the Powder River Basin, and CSX and NS in the East. Id. at 117, 118. The Board found "no evidence that railroads have colluded, overtly or tacitly, to maintain inefficient operations, unresponsive service, or above-market rate levels." Id. at 118. These reasons were upheld by the Court of Appeals in Western Coal Traffic League v. STB, 169 F.3d 775, 779 (D.C. Cir. 1999). A further, dramatic, illustration of intense two-railroad competition is in the rivalry between BNSF and UP/SP in the West on the routes where BNSF received trackage rights in the UPSP merger. That trackage rights condition was attacked precisely on the grounds that it would lead to collusion between the two railroads. See UP/SP, Slip op. at 116-17. Yet, over three years later, the Board found that:

> all indications are that both the UP/SP merger and the competitive conditions we imposed in UP/SP Merger are continuing to strengthen competition for railroad transportation in the West. Despite the participation of hundreds of shippers throughout the merger process and in our follow-up proceedings, no shipper has appeared here to even allege that this merger has resulted in any competitive harm.

UP/SP General Oversight, STB Finance Docket No. 32760 (Sub-No. 21), Decision No. 15 at 5 (STB served Nov. 30, 1999). DOT shares this overall assessment of "competitive benefits." Id.[18] The tremendous increase in rail output (revenue ton-miles) and decrease in real rates over the last two decades -- indicating that overall industry performance is competitive -- further supports the Board's view that railroads do compete vigorously in two-railroad markets.[19]

In addition to looking at actual experience, the Board also employs the tools of economic analysis in assessing the likelihood that a reduction from three-to-two competitors would reduce competition. This analysis examines the likelihood that the merger would increase the incentive or the ability of the two railroads in the formerly three-railroad market to profitably sustain tacit collusion. In UP/SP, and again in CN/IC, the Board found a number of industry characteristics that militate against a reduction in competition. These included the "heterogeneity of rail service, which would make it very difficult to maintain a tacitly agreed rate level"; the "secrecy about rail price and service offerings that now characterizes the rail industry"; and the

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[18]Further and detailed evidence of the vigorous competition brought about by the BNSF trackage rights can be found in BNSF's most recent Quarterly Progress Report in Finance Docket No. 32760. BNSF-PR-14 (Jan. 18, 2000).

[19]For example, revenue ton-miles increased by 63% between 1973 to 1998, and real rail rates fell by 46% between 1982 and 1996. Vellturo Statement at 7-8.

"significant economies of density and scope exhibited by railroads, " which create "strong incentives for railroads to compete for all profitable volumes, rather than tacitly agreeing to an above-market rate level that restricts service," UP/SP, slip op. at 267; accord CN/IC, slip op. at 29.[20] These incentives to compete are, if anything, increasing as a result of globalization: "source-and-destination based opportunities for products transported by North American railroads have expanded markedly as a result of trade liberalization in the U.S. and abroad. These increased opportunities place greater pressure on railroads to compete for traffic." Vellturo Statement at 21. Also, as the Board has recognized, where competition from other modes is significant, that is another factor making it unlikely that a reduction in the number of rail competitors from three to two would reduce competition. UP/SP, slip op. at 119.[21] As Dr. Vellturo concludes, a "presumptive finding of competitive harm in 'three-to-two' corridors or at 'three-to-two' shippers with respect to rail transportation is ill-advised, given the vastly complex arena within which railroads interact and compete." Vellturo Statement at 20.

The Board's approach combines experience and economic logic, and is consistent with the dramatically falling prices and increasing output of the industry, which are the key indicators of strong competition. This approach has proven accurate, and it is flexible enough to take

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[20]These are among the elements looked to under the framework established in the DOJ/FTC Merger Guidelines for the analysis of the likelihood of tacit collusion from a merger. See U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (1992) § 2.1, *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104.

[21]In UP/SP, the Board noted that the very fact that a merger will result in cost-reductions for the merged railroads is a "dynamic element" (in effect, a "downstream effect") which will "offset" any "limited ability . . . to raise rates over costs." Id. at 120.

account of any factors that bear on the likelihood of a reduction in competition from a three-to-two change. There simply is no reason to change it.

IX. MERGER-RELATED PUBLIC INTEREST BENEFITS

The ANPR asks for comment on "how claims of public interest benefits should be treated under our merger rules." ANPR at 9. The ANPR notes the suggestion by some that "merger applicants be required to show that any claimed synergies or other public interest benefits could not be achieved short of merger, through marketing alliances or cooperative operating practices." Id. And it notes the additional suggestion that the Board "should conduct post-merger monitoring to help ensure that the projected benefits are actually realized." Id.

In UP/SP, the Board rejected the suggestion that applicants should "have the burden of proving the negative proposition that merger benefits cannot be obtained through any means short of merger," slip op. at 111. The Board rejected this "novel" approach, which, it correctly noted, "goes against the grain of our statute." Id. Under the ICC's and Board's longstanding approach, parties opposing a merger are free to offer evidence to draw into question the transaction-relatedness of various public benefits. The Board evaluates such evidence while avoiding close second-guessing of business judgments, management initiatives, and shareholder votes. That is as it should be. There is no basis for a fundamental change to this approach.

Some parties during the Ex Parte No. 582 hearing cited the reduction in the number of Class I railroads, and the development of information technology ("IT"), as reasons for a different (but unspecified) approach to issues of merger-dependency. To take the first of these, a smaller number of railroads may of course be able to resolve certain problems that a larger number could not. For example, if a terminal gateway is now served by two railroads instead of five railroads, it becomes more likely that the two railroads will be able to build trains or larger blocks for interchange to the other railroad, whereas with five railroads, blocking and switching had to occur at the terminal because incoming trains had to be dispersed among all or most of the four other railroads. But these instances do not meet the main point: improved service between end-to-end railroads remains essentially what it has always been, an arms' length relationship between independent railroads that will endure only so long as each railroad perceives the arrangement to be in its self-interest. That is true whether the total number of Class I railroads is six or twenty-six. And the reasons that allow these bilateral relationships to progress to a point but ultimately limit them are the same today as they have been throughout the twenty years since the Staggers Act.

These Comments are not the place to rehearse all of those reasons, which are largely matters of common sense. Some brief discussion should suffice to show the lack of any basis for proposing a rule to deal with merger-dependency. Probably the most fundamental point is that, if profit-seeking railroads were able to realize greater efficiencies than they have, they would have done so; there is no reason why they would have left money on the table. As the Board observed in UP/SP, "if UP and SP have not yet been able to coordinate the core operations of their competing systems outside of the merger context, it is not realistic to suppose that they could easily do so, especially without the antitrust immunity that our approval confers." UP/SP, slip. op at 112. Dr. Vellturo points out that:

> If any other combination or contractual provision, including a VCA, long term contract, or joint marketing agreement, were a more efficient mechanism by which the parties could achieve additional cost savings or service/output enhancements than the proposed merger, then those alternatives would have been chosen by the merging parties as the more financially responsible use of their firms' scarce resources.

Vellturo Statement at 22.

There are many reasons why independently managed end-to-end railroads do not realize all of the potential efficiencies and service benefits that the two systems are capable of realizing, and that can be realized through management in a common economic interest. Independently managed railroads have different incentives; different sets of opportunities and opportunity costs; different business philosophies and willingness to take risks, which can limit the introduction of new services or other innovations; different corridor and commodity goals; different ways of measuring and assigning costs and determining contribution (profit); different access to capital and potential pay-outs from joint investments; different revenue potential on routes where one railroad would have a short haul; and a mutual disinclination to develop service on routes where both would have a short haul (but the combined route would be profitable for a single railroad). Even if railroads overcome these differences in particular situations, the transactions costs can be high.[22]

[22] As the ICC stated in Burlington N., Inc. – Control and Merger – Santa Fe Pac. Corp., Finance Docket No. 32549, Decision No. 38, slip op. at 52 (ICC served Aug. 23, 1995) ("BN/SF"): "In railroading, the most important joint process is the provision of interline service. By vertically integrating operations, railroads avoid the added disturbance of negotiations and accounting associated with divisions of joint rates, of disagreement over responsibility for providing cars, and of having to draft contracts that attempt to anticipate all issues that may cause disputes in the future. Elimination of these costs properly are included as public benefits of a rail

Railroads are networks, but alliances and other agreements relate to particular corridors and/or commodities, and, especially over time, may not represent the best commitment of resources for each railroad, given the changing set of opportunities and costs over each railroad's overall network. Full realization of end-to-end efficiencies and service enhancements requires both certainty and flexibility. Certainty as to the intentions and commitment of the other railroad is necessary to induce reciprocal commitments of resources, including human resources, management attention, and investment dollars. Flexibility is necessary because the world changes.

A contract can bring some certainty, for whatever the term of the contract is. But even contractual undertakings do not protect fully against unilateral changes in management priorities that may not amount to a breach but which reduce the effectiveness of the arrangement. At the same time, a contract can inhibit flexibility, since it obligates each railroad to actions that can only reflect each management's best predictions as of the time the contract is entered.

Only management in a common economic interest avoids these trade-offs and provides both certainty and flexibility. There is no longer any doubt about the intentions or commitment of another railroad. But, if conditions change, management is not inhibited by prior contractual obligations to another railroad from shifting priorities accordingly.

These considerations are not changed by the reduction in the total number of Class I railroads. It is not surprising that no attempt by a party to a major merger proceeding to

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merger."

demonstrate a significant lack of transaction-relatedness has ever succeeded, despite the Board's repeated and careful consideration of such evidence.[23]

Similarly, the remarkable developments in IT do not remotely support a fundamental change to the Board's approach to transaction-relatedness. IT can facilitate cooperation and create new shipper-benefits from cooperation. But IT of itself does not resolve most of the barriers noted above that stand in the way of fully realizing efficiencies and shipper benefits across independent end-to-end networks. IT cannot compel independent railroads to agree. If one railroad wants to offer a new train in advance of shipper commitments, and the other railroad wants to build shipper commitments before offering the new train, IT will not resolve that difference, which reflects different, and legitimate, business philosophies and willingness to incur risk, either in general or with respect to the particular service.

Thus, shifting the burden or otherwise changing the standards with respect to merger-dependency will, for the vast majority of public benefits, simply prolong and complicate the way to an almost inevitable conclusion that the benefits are indeed not likely to occur without the merger. The costs of reconfirming this expectation each time, however, would be substantial. At the least:

> the parties will be required to demonstrate (and the Board to evaluate) the cost-benefit trade-offs of a vastly complex series of hypothetical potential joint ventures, VCAs, long-term contract, and/or access agreements. The evidentiary

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[23]<u>See, e.g.</u>, <u>UP/SP</u>, slip op. at 111 ("one of the major problems with [the witness's] analysis is that he assumes that major service coordinations <u>of the scale that will take place here</u> can be accomplished through voluntary trackage rights and other joint agreements without the stimulus of a merger.") (emphasis added); <u>UP/MP</u>, 366 I.C.C., at 492-93; <u>CN/IC</u>, slip op. at 47.

> and time burdens associated with this analysis on the parties and Board would be immense, and . . . subject to potential opportunism by competitors and other third parties seeking to delay or dampen the procompetitive impacts of a business combination.

Vellturo Statement at 21.

With respect to the suggestion of post-merger monitoring of merger benefits, CN notes that the Board now imposes oversight conditions when it approves a major merger. For example, in the CN/IC decision, the Board imposed a five-year oversight provision to consider the progress of implementation, the effectiveness of the conditions that were imposed, and various other matters that had arisen in the course of the proceeding. See CN/IC, slip op. at 39; Canadian Nat'l Ry. – Control – Illinois Cent. Corp. (General Oversight), Finance Docket. No. 33556 (Sub-No. 4), Decision No. 1, at 3 (STB served March 9, 2000). It is not evident what the proponents of monitoring may have in mind over and above this type of oversight condition.

Further post-transaction monitoring to track benefit-by-benefit would serve no purpose unless the Board had approved the merger despite substantial unremedied anticompetitive effects or other public costs. Only in that unlikely circumstance might a fairly precise balancing of public costs and benefits have been critical to the approval. As already pointed out, however, the Board no longer approves mergers with substantial unremedied anticompetitive effects or other public costs not cured by conditions. Absent any public costs, a merger may well be consistent with the public interest regardless of the extent of its public benefits. In any event, in light of the Board's unwillingness to allow a merger with unremedied public costs, and in light of the proven effectiveness of the Board's standard types of conditions, a general rule for post-transaction monitoring of public benefits would serve no purpose.

Moreover, turning applicants' good-faith estimates of public benefits into benefity-by-benefit "guarantees" would needlessly chill beneficial transactions. And monitoring would require railroad managements to explain to the Board when changing conditions made it preferable to pursue efficiencies, investments, or service enhancements, other than those described in the application, and would involve the Board in second-guessing market analyses and business judgments. Timing issues would be difficult; suppose, for example, the merged railroad was realizing projected gains, but more slowly than anticipated. Or, suppose it had realized some benefits more rapidly, or to a greater extent, than projected in the application, and other benefits more slowly or to a lesser extent than predicted; would there be a netting? Or, suppose the railroad had failed to realize certain projected benefits, but had realized others not anticipated in the application.[24] Further, it is not at all evident what an appropriate remedy would be in the event that, under some standard, the Board concluded that the merged railroad was not satisfactorily realizing projected benefits. The Board should not propose a rule with respect to post-transaction monitoring of benefits.

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[24] In UP/SP, the Board noted that BNSF had projected annual benefits of $[illegible]50 million but that subsequent to consummation had identified another $400-$500 million. UP/SP, slip op. at 110 & n.108.

X. CROSS-BORDER ISSUES

The Board stated three potential concerns in the ANPR with respect to so-called "cross border issues." ANPR at 10. First, cross-border ownership could potentially impact FRA and the Department of Defense ("DoD") – specifically, cross-border ownership could lead to "uncertainty" about "the adequacy, consistency, and effectiveness of extra-territorial oversight" with respect to "FRA's ability to exercise its safety authority," and "predominant foreign control of a large U.S. railroad might adversely affect our nation's defense operations," because DoD "relies on rail transportation in wartime." Id. Second, "foreign control of railroads operating in the United States could lead to traffic shifts that could have significant adverse financial impacts on U.S. ports and waterway systems." Third, "a merger of a Canadian carrier with a large U.S. carrier could unfairly disadvantage [U.S.] product in competition with Canadian grain and lumber in our domestic markets."

These "cross border issues" require no merger rules. Even before the CN/IC merger, there was a long history of major U.S. railroads' being owned or controlled by Canadian railroads.[25] There has never been any showing of adverse impactson safety, national defense, service to U.S. shippers, or port traffic. Concomitantly, the major U.S. railroads (with the

[25]CP has long owned Soo (a Class I railroad) and has more recently acquired an ownership interest in IMRL, which operates in Illinois, Iowa, Missouri and Minnesota. Long before acquiring control of IC, CN owned Grand Trunk Western (also a Class I railroad), the Sarnia Tunnel and a 50% interest (with CP) in the partnership that owns the St. Clair Tunnel.

exception of only UP) operate in Canada, also without raising, on either side of the border, the cross-border concerns mentioned in the ANPR.[26]

The long history of cross-border ownership and operation thus demonstrates the lack of legitimate concern with respect to the impacts that cross-border ownership may have on safety. Parties to the Ex Parte No. 582 proceeding, for example, did not show diminished safety because of problems with the effectiveness of FRA's oversight. Neither the U.S. operations of Canadian-owned U.S. railroads nor the Canadian operations of U.S.-owned railroads have given rise to safety problems.

Nor has there been any reason for concern that U.S. defense operations have been adversely effected by control of U.S. railroads by corporations incorporated in Canada – itself a major partner with the U.S. in defense agreements and operations. All of the normal economic incentives regarding the provision of service apply to DoD, which is a shipper (as are the industries that supply defense needs). So do all of the service obligations that attend a railroad operating in the U.S., regardless of ownership. And railroad boards of directors are bound by fiduciary obligations that would be violated if they were to attempt to subsume economic incentives and behavior to a national political agenda. Such a violation could not possibly remain undetected and would engender the most serious government-to-government responses.

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[26]For example, BNSF serves the port of Vancouver, British Columbia, and Winnipeg, Manitoba; NS has a substantial presence along the Northern shore of Lake Erie in Southern Ontario; and CSX serves Sarnia and Windsor, Ontario and Montreal, Quebec. Additionally, a smaller carrier, Emons Transportation's St. Laurence & Atlantic, connects Quebec Province and northern New England.

In any event, in the case of CN, potential concerns regarding "foreign control" are particularly misplaced, because CN is a Canadian corporation that is 80% owned by U.S. stockholders.[27]

Moreover, special rules for transactions involving Canadian companies would raise serious issues under the North American Free Trade Agreement ("NAFTA"). Under NAFTA, the U.S. has entered into a reciprocal agreement that generally affords Canadian investors and investments "treatment no less favorable than that [the U.S.] accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments." NAFTA Article 1102; see also id. at 1105 (guaranteeing minimum standards of "fair and equitable treatment and full protection and security"). To now make special rules that would hinder or impede the ability of Canadian railroads to merge with U.S. railroads would be contrary to the NAFTA goal of "facilitat[ing] the cross border movement of goods and services" and cross-border investment between the U.S. and Canada. NAFTA Art. 102(1)(a).[28] Even in individual merger proceedings, the Board should be

[27]During the Ex Parte No. 582 proceeding, DoD expressed concern that mergers could bring about abandonments that would impair defense capabilities. But, if the Board is correct that there is little more to be accomplished in the way of shedding unproductive assets, future mergers are unlikely to include abandonment proposals. CN and BNSF, for example, anticipate no proposals for abandonments in their merger application. Abandonments subsequent to a merger would require separate Board approval pursuant to 49 U.S.C. § 10903. If and when railroads propose abandonments, the Board may take defense concerns into account under the "public convenience and necessity" standard of that section.

[28]In particular, NAFTA seeks to deflect unilateral action by establishing an international committee to review matters such as rail safety regulations. See NAFTA Article 913.5(a)(i) and Annex 913.5.a-1(2)(b). The U.S. has assigned to this committee the Department of Transportation's Director of International Transportation and Trade, and not a member of the Board or its staff, which may reflect, among other reasons, the fact that FRA is an agency within

wary of requests for protections that, individually or cumulatively, could undermine the enormously successful commitment of the U.S. to liberal trade policies across North America. Absent the most compelling and specific showings in the context of a particular transaction, such matters should be considered the responsibility of the federal departments and agencies whose primary missions are foreign policy and international trade.

The other two potential cross-border issues identified by the Board also concern international trade, and they are also best left to international trade processes and the expertise that has come to bear in those processes. For example, the Board expressed concern that domestic lumber might be disadvantaged in competition with Canadian lumber. There is a long-standing international trade dispute over U.S.-Canada lumber that has been a matter of public discussion, governmental investigation, and international negotiation and arbitration for many years. That dispute is not related to past or future mergers nor is it a matter to be legitimately resolved in the course of a merger proceeding. Any similar dispute over grain should likewise be left to international trade dispute mechanisms.

Likewise, the Board's concern with the potential effect of cross-border traffic flows on ports is a matter of the consequences of a change in the flow of international trade. The Board should leave such matters to the process of international trade agreements, such as the NAFTA. Moreover, the possibility of traffic shifts that could have significant adverse impacts on certain U.S. ports and waterway systems is no different from shifts among U.S. ports that may result

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DOT, not STB.

from wholly-U.S. transactions, and does not require any new rules. If such shifts occur, they would be due to market forces such as route efficiencies and shipper preferences. The Board should not attempt to deny shippers (and, ultimately, U.S. consumers) the benefits of efficiencies resulting from mergers between U.S. and Canadian railroads. Particularly is this so when the shifts in question are unlikely to be anywhere near a magnitude that would "imperil the significant public investment in . . . port facilities." No one has presented the Board with specific evidence demonstrating that there would be harm of such magnitude, and the Board should consider the matter too speculative to merit rules for drastic marketplace intervention.

XI. SPECIFIC TECHNICAL RULE CHANGES

CN is submitting as an attached Appendix suggestions for technical changes to the Board's rail consolidation procedures governing the content of applications. Applicants in "major" proceedings typically seek and are granted waivers of these provisions. The suggested revisions would bring the procedures into line with what CN understands to be the Board's actual information needs.

CONCLUSION

The ANPR invites comment on a number of industry-wide policy matters that should be treated as such, outside the context of a rulemaking directed to merger issues, including the question of a two-railroad U.S. transcontinental structure. CN believes that there is opportunity for the Board to refine elements of the public interest standard relating to mergers, in particular to ensure that there will not be severe service disruptions during the implementation phase. CN's examination of the merger issues should confirm that the Board can resolve these types of issues as well or better in the context of individual merger proceedings. In light of the Board's preference to consider certain refinements of the public interest standard as possible amendments to its rules, CN suggests a number of amendments. Should the Board choose to amend its rules, it should maintain the approach of the present Guidelines, under which parties may test and invite the Board to reconsider or elaborate its standards in individual merger proceedings.

Respectfully submitted,

Paul A. Cunningham /RBH

Jean Pierre Ouellet
CANADIAN NATIONAL RAILWAY COMPANY
P. O. Box 8100
Montreal, PQ H3B 2M9
(514) 399-5430

Paul A. Cunningham
Richard B. Herzog
HARKINS CUNNINGHAM
801 Pennsylvania Avenue, N.W., Suite 600
Washington, D.C. 20004-2664
(202) 973-7600

Attorneys for Canadian National Railway Company

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APPENDIX
SUGGESTED TECHNICAL AMENDMENTS

There are certain provisions of the Board's railroad consolidation procedures, governing the content of applications, that are rarely used and/or are the subject of petitions for waiver or clarification in nearly every control proceeding that is classified as "major" under the Board's rules.[29] The consistent practice of the Board and of applicants has made it apparent that the regulations in their current form do not reflect the actual needs of the Board for information about transactions presented for its approval. CN therefore recommends that the Board amend its regulations to bring them into line with the Board's actual needs for information that is relevant and material, and with its past practice in major control proceedings, thus avoiding the necessity for applicants to submit or the Board to process the lengthy and largely boile-plate petitions that have come to be typical in such proceedings. The appropriate revisions in this category are ones regarding the subjects listed below.

[29] See Union Pac. Corp. – Control – Chicago & N.W. Holdings, Inc., Decision No. 32133, Decision No. 3 (ICC served Oct. 26, 1992); Burlington N., Inc. – Control & Merger – Santa Fe Pac. Corp., Finance Docket No. 32549, Decision No. 3 (ICC served Oct. 3, 1994); Union Pac. Corp. – Control & Merger – Southern Pac. Rail Corp., Finance Docket No. 32760, Decision No. 3 (ICC served Sept. 5, 1995); CSX Corp. – Control & Merger – Conrail Inc., STB Finance Docket No. 33220, Decision No. 7 (STB served Jan. 24, 1997); Norfolk S. Corp. – Control – Conrail Inc., STB Finance Docket No. 33286, Decision No. 5 (STB served Feb. 21, 1997); NS/CR; CSX Corp. – Control & Operating Leases/Agreements – Conrail Inc., STB Finance Docket No. 33388, Decision No. 7 (STB served May 30, 1997); Canadian Nat'l Ry. – Control – Illinois Cent. Corp., STB Finance Docket No. 33556, Decision No. 6 (STB served Aug. 14, 1998).

A. Definition of "Applicant."

Recommendation. The Board should amend its rules to add the following sentence at the end of 49 C.F.R. § 1180.3: "The term 'applicant' does not include a wholly-owned direct or indirect subsidiary of an applicant, if that subsidiary is not a rail carrier."

Discussion. Section 1180.3(a) of the Railroad Consolidation Procedures defines "applicant" as one of the "parties initiating a transaction." Many of the major control proceedings before the Board involve transactions in which one rail carrier or railroad holding company enters an agreement with a second rail carrier or holding company, in which one of the parties sets up a shell corporation to serve as the vehicle for acquisition of or merger with the other (e.g., in a triangular merger context).[30] Typically, such shell corporations are wholly owned subsidiaries of one of the parties to the transaction. They have no interests or volition independent of those of their parents and thus cannot meaningfully be considered to be "initiating [the] transaction." Even where such corporations are parties to a merger agreement (and thus arguable are, in a formal sense, among the initiators of a transaction), there is no benefit to the Board, other parties to the proceeding, or the public from characterizing those entities as "applicants" for purposes of the Rail Consolidation Procedures.[31]

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[30]Such corporations often bear names containing such terms as "Holding" or "Acquisition."

[31]The practical effect of such a characterization is to require (1) that the entity's president or similar officer sign the application, (2) that the application contain a certification, by the entity's secretary, that the president or other officer is duly authorized to verify and file the application, (3) that the application state the entity's name, business address, telephone number, and the name of counsel to whom questions regarding the transaction can be addressed, (4) that

In addition, Class I rail carriers are often part of corporate families headed by a holding company, in which one or more intermediate non-carrier holding companies are direct or indirect subsidiaries of the ultimate holding company, and are at the same time the direct or indirect parent of one or more rail carriers. In such cases, as in the case of a shell company created as a vehicle for a merger or similar transaction, the intermediate holding company has no interests or volition independent of those of the ultimate holding company, and there is no benefit to be gained by regarding the intermediate company as an "applicant."

Nevertheless, parties to a rail merger or control transaction have frequently, in an abundance of caution, asked the Board to declare that shell companies or intermediate holding companies of the kind described above need not be regarded as "applicants" within the meaning of the Rail Consolidation Procedures. It would therefore be appropriate for the Board's rules to state explicitly, in language applicable to all forthcoming transactions, that the term "applicant" does not include shell corporations set up solely for the purpose of being the instrument through which control is obtained.

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the application contain a certificate by the entity's counsel that that the transaction meets the requirements of the law and will be legally authorized and valid, if approved by the Board, and (5) that the application describe the type of business in which the entity is engages, the length of time in which it has been so engaged, and any present or prospective activities of the entity related to Board-regulated transportation. 49 C.F.R. § 1180.4(c)(2)(i), -.6(a)(1)(i), -.6(a)(4), -.6(b)(7).

B. Definition of "Applicant Carrier."

Recommendation. The heading and first sentence of 49 C.F.R. § 1180.3(b) should be amended to read as follows:

> (b) *Applicant carriers*. All applicants that are rail carriers, and all rail carriers regulated by the Board under 49 U.S.C. § 10501 in which any applicant holds a direct or indirect ownership interest greater than 50%.

Discussion. Section 1180.3(b) of the Railroad Consolidation Procedures defines "applicant carriers" to include "all carriers related to the applicant and all other carriers involved in the transaction." An application under the Rail Consolidation Procedures must contain detailed corporate and other information about every entity falling within this definition, including:

- copies of the most recent Form 10-K for each such entity (§ 1180.6(b)(1));
- copies of the most recent Form S-4 registration statement (or equivalent) (§ 1180.6(b)(2));
- indication of all changes in officers not listed on the most recent Form R-1 (§ 1180.6(b)(3));
- the two most recent annual reports issued to the entity's shareholders (§ 1180.6(b)(4)).

The regulations do not define either "carrier" or "related." At the time the Railroad Consolidated Procedures were adopted, however, those rules applied to any transaction in which a rail carrier acquired control of or was brought under common control with another rail carrier, an express carrier, a sleeping car carrier, a water commo carrier, a motor carrier, or a water carrier. 49 U.S.C. § 11343(a) (1994) (repealed). It is therefore reasonable to conclude that the term "carrier" in § 1180.3(b) extends to any such entity. Since enactment of the ICC Termination Act of 1995, on the other hand, the Board's rules no longer apply to any control transaction other than one between or involving rail carriers, and the Board has no need for a rail control application to contain detailed information about non-rail carriers (or, for that matter, about any carrier not regulated by the Board.[32] Accordingly, applicants in major control provision have typically sought, and the Board has typically granted, waivers from any requirement to treat non-rail carriers or carriers with no U.S. operations as "applicant carriers" for purposes of the regulations.

In addition, although the definition does not explain what carriers should be characterized as "related to" an applicant, applicants in recent control transactions have obtained waivers or clarifications stating that "applicant carriers" do not include any carrier in which an applicant does not have an ownership interest greater than 50%.

Because such waivers and clarifications are routinely granted, § 1180.3(b) should be amended to reflect their substance, and to provide that "applicant carriers" include only those Board-regulated rail carriers in which any applicant has an ownership interest, direct or indirect, of more than 50%.

[32] For example, the Board does not need detailed corporate information about carriers that have no operations in the United States and over which it has no jurisdiction.

C. Information About Labor Impacts.

Recommendation. The Board should amend 49 C.F.R. § 1180.6(a)(2)(v) to read as follows:

> (v) The effect of the proposed transaction upon applicant carriers' employees in the United States (by class or craft or non-agreement status), the geographic points where the impact will occur, the time frame of the impact (for at least 3 years after consolidation), and whether any employee protection agreements have been reached. This requirement is satisfied if the application includes a list of all employee protection agreements, and if all other information required is set forth in a chart in substantially the following format:

EFFECTS ON APPLICANT CARRIERS' EMPLOYEES

Current Location	Classification	Jobs Transferred to	Jobs Abolished	Jobs Created	Year

Discussion. Section 1180.6(a)(2)(v) of the Railroad Consolidation Procedures requires an applicant to discuss the "effect of the proposed transaction upon applicant carriers' employees (by class or craft), the geographic points where the impact will occur, the time frame of the impact (for at least 3 years after consolidation), and whether any employee protection agreements have been reached." This regulation is included in order to enable the Board to discharge its statutory obligation to take account of "the interest of rail carrier employees affected by the proposed transaction" and to provide employee protective arrangements as required by law, 49 U.S.C. §§ 11324(b)(4), 11326(a).

Those obligations, however, only extend to employees in the United States, as the Board's predecessor, the ICC, recognized when it held that it was neither required nor permitted to impose conditions in a rail control proceeding for the protection of the interests of employees outside the United States. Great N. Pac. & Burlington Lines, Inc. – Merger – Great N. Ry.; In the Matter of Van Blaricom, 6 I.C.C.2d 919, 929 (1990). Since the Board has no authority to impose conditions protecting employees outside the United States, there is little purpose to requiring applicants to include detailed information about labor impacts abroad. The Board should therefore amend its rules to clarify that detailed information about employee impacts § 1180.6(a)(2)(v) to add the words "in the United States" after the words "The effect of the proposed transaction upon applicant carriers' employees."

In addition, the rule does not explain the format in which the labor impact should be submitted, and applicants therefore typically seek and obtain clarifications that the requirements of the rule will be satisfied by submission of a chart containing a standard format. The Board should therefore amend § 1180.6(a)(2)(v) to make reflect the substance of those clarifications.

D. Form 10-K.

Recommendation. The heading and first sentence of 49 C.F.R. § 1180.6(b)(1) should be replaced with the following:

> (b) Form 10-K (exhibit 6). Submit (i) the most recent filing with the Securities and Exchange Commission (SEC) under 17 CFR 249.310 by each applicant, if made within the year prior to the filing of the application, and (ii) the most recent filing with the SEC under 17 CFR 249.310 by any entity that is in control of an applicant, if made within the year prior to the filing of the application.

Discussion. Section 1180.6(b)(1) of the Railroad Consolidation Procedures requires the filing of applicant carriers' most recent Form 10-K with the Securities and Exchange Commission ("SEC"). In many cases, however, the rail carriers involved in a control proceeding are wholly owned subsidiaries of a non-carrier holding company, have no publicly traded securities. In this event, application of the literal terms of the rule would require submission of any Form 10-K that may have been filed before the railroad set up a holding company structure, and would not require submission of the holding company's current Form 10-K, even though the latter and not the former would be of any use to the Board in evaluating the transaction presented for its approval. Applicants therefore typically seek and obtain waivers of this requirement that would permit them to submit the Form 10-K for the appropriate holding company. The Board should amend § 1180.6(b)(1) to make this option available in all cases in which a railroad has no publicly traded securities.

E. Form S-4 (formerly S-14).

Recommendation. The heading and first sentence of 49 C.F.R. § 1180.6(b)(2) should be replaced with the following: "Form S-4 (exhibit 7). Submit the most recent filing with the SEC made under 17 CFR 236.25 by each applicant, and by each entity controlling any applicant, with respect to any security related to the transaction that is the subject of the application." The second sentence of 49 C.F.R. § 1180.6(b)(2) should be amended by striking out "Form S-14" and inserting "Form S-4" in lieu thereof.

Discussion. Section 1180.6(b)(2) of the Railroad Consolidation Procedures requires applicants to "[s]ubmit applicant carriers' most recent filing with the Securities and Exchange Commission (SEC) under 17 CFR 249.310." The heading to this section is "Form S-14," reflecting the fact that when the Railroad Consolidation Procedures were adopted, the SEC required filing of Form S-14 as a registration statement for securities issued in connection with a merger or acquisition of control. Since then, the SEC has replaced Form S-14 with Form S-4, which is described in the SEC's rules at 17 C.F.R. § 236.25, rather than the section cited in § 1180.6(b)(2). And as in the case of Form 10-K, application of the rule by its literal terms would be inappropriate in any context where the rail carrier involved is not publicly traded, and where any relevant registration statement would be issued by a non-carrier holding company. Applicants therefore typically seek and obtain waivers permitting them to submit the Form S-4 that actually relates to the transaction before the Board. Accordingly, the Board should amend § 1180.6(b)(2) to make this option available in all cases in which a railroad has no publicly traded equity securities, in language substantially identical to that submitted in the appendix.[33]

[33]The proposed language would also limit the requirement of this section to registration statements issued in connection with the subject transaction. This limitation would ensure that, if a transaction would not require issuance of new securities, the applicants would not be obligated to submit a Form S-4 that might have been filed earlier in some other context, and that would be irrelevant to the transaction before the Board.

F. Change in Control.

Recommendation. CN recommends that the Board amend 49 C.F.R. § 1180.6(b)(3) to read:

> (3) Change in control (exhibit 8). Indicate any change in ownership, control, or officers of any applicant carrier not indicated in the most recent annual report Form R-1. If any applicant carrier does not submit a Form R-1, then (i) list all officers of the applicant carrier, and (ii) identify (A) the person(s) or entity/entities in control of the applicant carrier, or (B) all owners of 10% or more of the equity of the applicant carrier.

Discussion. Section § 1180.6(b)(3) of the Railroad Consolidation Procedures requires applicants to "[i]ndicate any change in ownership, control, or officers not indicated in the most recent annual report Form R-1." As only Class I rail carriers submit Form R-1, it is not clear what this rule requires with respect to Class II and III rail carriers that qualify as applicant carriers under the Board's rules. This section should therefore be amended to provide explicitly for submission of the names of officers and directors of rail carriers that do not file a Form R-1.

G. Annual Reports.

Recommendation. The heading and first sentence of 49 C.F.R. § 1180.6(b)(4) should be replaced with the following:

> (4) Annual reports (exhibit 9). Submit (i) the two most recent annual reports issued by each applicant to its stockholders, if issued within the three years prior to the filing of the application, and (ii) the two most recent annual reports issued by each entity that is in control of an applicant, if made within the three years prior to the filing of the application.

Discussion. Section 1180.6(b)(4) of the Railroad Consolidation Procedures requires that applicants submit each applicant carrier's two most recent annual reports to stockholders. Application of this rule according to its terms could result in the anomalous situation in which an applicant would be required to locate and submit copies of annual reports that were issued many years ago, before the railroads set up holding companies, but not to submit copies of the recently issued holding company annual reports. This section should therefore be amended to embody the substance of the waiver that is typically sought and granted in major control proceedings, permitting applicants to submit the annual report of the holding company.

H. Corporate chart.

Recommendation. The second sentence of 49 C.F.R. § 1180.6(b)(6) should be amended by replacing the second sentence (which begins "For each company include a statement") with the following:

> Identify each company on the chart that is a rail carrier subject to the jurisdiction of the Board under 49 U.S.C. § 10501. Identify any officers or directors common to any two or more such rail carriers, other than rail carriers operated under common control or management under circumstances defined in 49 C.F.R. § 1185.5.

Discussion. As presently written, 49 C.F.R. § 1180.6(b)(6) requires applicants to indicate all situations in which a person hold positions in two or more companies listed in the corporate chart. As most Class I railroads are part of corporate families that may contain dozens of entities, many of which share officers or directors, compliance with this requirement could be extremely burdensome to, and applicants therefore typically seek and receive waivers that would minimize that burden.

To the extent that officers and directors of a rail carrier are shared by other rail carriers within the same corporate family, that sharing simply reflects a control relationship that, unless it predates the Transportation Act of 1940, must either have been approved as consistent with the public interest or have been exempted from regulation. Moreover, to the extent that such officers or directors are shared with non-rail-carrier entities within the same corporate family, that fact has little or no bearing on whether a proposed transaction meets the public interest standard the Board must apply in evaluating that transaction. On the other hand, situations in which two or more rail carriers not under common control share officers or directors could be relevant to that determination. In such situations, one rail system could exercise its influence upon another rail system or railroad less obviously than in the case of outright control, and the Board might therefore prefer to have such instances brought to its attention. (For example, if two railroads apply for authority to merge, and each share officers with a third railroad, the Board might find the combined influence of the two applicants on the third railroad to be significant – and possibly anticompetitive – even if the proposed merger would not clearly give the combined entity control over the third railroad.) Accordingly, CN would propose that applicants be permitted to disregard common officers and directors within a single corporate family, and instead to report only those instances in which two or more railroads from different corporate families share officers or directors.

I. Intercorporate Relationships.

Recommendation. CN recommends that the Board replace the first sentence of 49 C.F.R. § 1180.6(b)(8) with the following:

> (8) Indicate whether there are any direct or indirect intercorporate or financial relationships at the time the application is filed, not disclosed elsewhere in the application, through holding companies, ownership of securities, or otherwise, in which applicants or their affiliates own or control more than 5% of the stock of a non-affiliated rail carrier regulated by the Board, including those relationships in which a group affiliated with applicants owns more than 5% of the stock of such a rail carrier. (For purposes of this paragraph, "affiliates" has the same meaning as "affiliated companies" in Definition 5(b) of the Uniform System of Accounts, 49 C.F.R. Part 1201, Subpart A.)

Discussion. Section 1180.6(b)(8) requires applicants to provide information about certain intercorporate or financial relationships between applicant carriers and carriers in other corporate families. In the past several major rail control proceedings, applicants have sought and obtained waivers that have permitted them to disregard de minimis relationships when providing this information. The Board should therefore amend 49 C.F.R. § 1180.6(b)(8) to reflect the substance of those waivers and to provide that the requirement only extends to those relationships involving ownership by Applicants or their affiliates of more than 5% of a non-affiliated carrier's stock, including those relationships in which a group affiliated with Applicants owns more than 5% of a non-affiliated carrier's stock.

I. Financial Information.

Recommendation. The Board should amend its rules to delete the beginning clause of 49 C.F.R. § 1180.9 and to insert in lieu thereof the following:

> For *major* transactions, the application shall contain *pro forma* financial statements showing the effects of the transaction. Notwithstanding any other provision of this section 1180.9, applicants may prepare the *pro forma* financial statements on a consolidated basis if that method of presentation is reasonably appropriate to portray the financial effects of the transaction on the railroads that are the subject of the transaction.

Discussion. In the past several major control proceedings, applicants have submitted pro forma balance sheet, income statement, and sources and application of funds statements, required by § 1180.9(a)-(c), on a consolidated basis. These submissions have not aroused any controversy, and have provided the Board with more meaningful information that has improved the ability of the Board to evaluate financial effects of the proposed transaction. The Board should therefore amend its rules to clarify that applicants may submit financial pro formas on a consolidated basis where appropriate to effective portrayal of the financial consequences of the transaction on the railroads involved.

Before The Surface Transportation Board

Ex Parte No. 582 (Sub-No. 1)

Major Rail Consolidation Procedures

Statement of Christopher A. Vellturo, Ph.D.

May 16, 2000

I. OVERVIEW OF STATEMENT

On March 31, 2000, the Surface Transportation Board (the "Board") issued an Advanced Notice of Proposed Rulemaking on major rail consolidation procedures (the "ANPR"). The Board stated, "the time has come for us to consider whether we should revise our rail merger policy... with any eye toward affirmatively enhancing, rather than preserving, competition."[1]

The Board identified a number of other specific policy areas that it proposes to reevaluate as part of its analysis of the Board's overall regulatory position toward railroad mergers. These policy areas include downstream effects, competitor access, the "one-lump" theory, "three-to-two issues" and strategic alternatives to mergers, among others.

I have applied my training and experience as an economist to evaluate the current status of the rail industry, the role mergers will play in the future health and stability of the rail industry, and the regulatory changes that the Board is considering. This comment presents my findings. I have studied antitrust issues in general, and rail policy issues in particular, over the past seventeen years. I have extensive antitrust expertise and experience with respect, in particular, to the competitive ramifications of mergers and acquisitions. My work on competitive analyses of over 100 transactions in the last seven years has spanned a broad array of North American industries that rely on rail transportation for their competitiveness, including grains and agricultural products, sugar, salt, fertilizers, chemicals, and forestry products, among others. My experience in these projects bears directly on the conclusions I have reached with respect to the general policy questions and specific combination-related issues currently under consideration by the Board. (My vita is attached as Exhibit 1.)

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[1] ANPR pp. 4-5.

I have considered the Board's proposals and have analyzed the potential these changes have to serve the public interest. Based on my analysis, I reached the following conclusions.

- Railroads remain in the best position (and are mandated by their fiduciary responsibilities to their shareholders) to undertake the complex and fact-intensive process of identifying and evaluating efficient and profitable ventures, including mergers. This Board historically has enabled these undertakings to proceed successfully, while implementing on a case-by-case basis necessary safeguards against the exercise of market power. This ability ensured that business combinations and other strategic actions of railroads, under careful review by the Board, served the public interest. By continuing to employ this careful, case-by-case evaluation of business combinations, the Board will continue to protect and enhance the welfare of consumers, shippers and railroads.
- Railroads have not exhausted the welfare-enhancing benefits of mergers. The reduction of redundant capacity formed a basis for significant efficiencies and increased viability achieved through merger in the twenty years since the Staggers' Act. It by no means represented the sole significant basis for improvements in rail service and efficiency. Indeed, key factors — including network reconfiguration and extension, enhanced economies and product differentiation through length of haul increases, and improved utilization and management of rolling stock — continue to offer the potential for large gains in efficiency and social welfare through merger.
- Some specific proposals for enhancing competition that the Board considers addressing in rail merger proceedings, including most notably competitive access, should not be addressed in the context of the Board's merger policy. A consideration of these factors in the context of a merger review would add to the regulatory uncertainty associated with potentially pro-competitive and welfare-

enhancing transactions and would distort the incentives of railroads to undertake welfare-enhancing combinations by imposing external costs on the combination. Such a policy would not solve any transaction-specific issues and could prevent the consummation (or even the proposal) of welfare-enhancing combinations. If the Board were to determine that the public interest would be served well by considering nonmerger issues such as competitive access, these issues should be considered outside of the merger review process to avoid imposing costs on proposed mergers that would distort incentives to consider welfare-enhancing transactions.

- Other policy areas, for example "three-to-two" evaluations, require careful, fact-specific consideration on a case-by-case basis and cannot be resolved through a general policy position.

The remainder of this statement provides the economic framework and analytic bases for these conclusions.

II. General Economic Issues Relating to Rail Merger Policy

A. Merger Retrospective

With the 4-R Act and Staggers Rail Act of 1980 (and related regulatory actions), Congress and rail regulators sought to enable railroads to undertake the structural and strategic changes necessary to achieve viability while preserving competition. These changes included freedoms to contract with shippers, to price differentially, to undertake network and employment rationalizations, and to offer innovative products and services. No one questions the success of these initiatives. Railroad viability generally has been restored while rail prices have fallen in both real and nominal terms.

This return to viability has been executed (in substantial part) through an extensive sequence of rail mergers and acquisitions. These mergers have enabled railroads to rationalize rail networks through network expansion and selective abandonment, to improve efficiency, to consolidate management, to introduce innovative technologies and management techniques and to invest in capital and information technologies for effective management of rolling stock.

The resulting merger dynamic has been highly efficient from a regulatory and welfare policy perspective. This approach enfranchised the railroads themselves (rather than social planners) with the ability to identify the structural reconfigurations of their networks that maximized value to their constituent shareholders. The "market mechanism" was used to identify railroad strategies that increased social welfare through more efficient operation and enhanced competition. Railroads collected information and evaluated available options from the standpoint of profit maximization with the clear understanding, as a result of the Board's experience and effectiveness in preventing anticompetitive effects, that additional profitability through the creation or enhancement of market power would not be realized. Railroads sought to identify and pursue network restructuring and reconfiguration that were in the public interest with a minimum of regulatory intervention.

Again, no one questions that a significant component of the efficiencies realized through rail mergers were generated through downsizing. For example, in 1976, fifty-two Class I railroads in the United States maintained 185,000 miles of road.[2] At present, five U.S. Class I railroads remain along with Canadian National's U.S. presence (the GTW and IC) and Canadian Pacific's U.S. presence. In 1998, these railroads owned only 101,000 miles of road, 45 percent less than that owned in 1978.[3]

But reduction of redundant and excess capacity is only part of the story. Since 1980, railroads have improved viability not only by shedding unprofitable lines and combining existing

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[2] "Railroad Facts," Association of American Railroads, 1986, p. 42.
[3] "Railroad Facts," 1999, p. 44.

traffic onto more efficient systems, but also by expanding output through innovations in technology and management, by enhancing service quality and by reducing prices. For example, the rise of intermodal containerization in the 1980s reflects each of these changes. Network rationalization and the ability to negotiate long-term service contracts enabled railroads to serve their customers by undertaking specific investments. These investments to offer competitive intermodal service included capabilities for double-stacking containers and improved interline capabilities.

Proposed merger efficiencies have largely been realized (though at times with significant transitional delays and costs). The Board has sought to maintain competition through Board-initiated access provisions at so-called "two-to-one" points, and monitoring of post-combination performance. This sequence has resulted in an established and predictable regulatory approach to evaluating rail mergers. Mergers that generate net efficiencies and increase welfare will be permitted but only with a review process in place to ensure that opportunities for enhanced profitability through the exercise of market power do not survive the process.

Recent rail mergers have enhanced efficiency and output with relatively greater emphasis on expanded single-line operations. This emphasis is illustrated dramatically by increases in Average Length of Haul ("ALOH"),[4] arising in part from rail consolidation in recent years. In addition to exploiting opportunities to combine/divest low-density traffic routes, rail mergers of

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[4] ALOH is defined as the ratio of total revenue ton-miles of freight to revenue tons of freight. (See http://www.stb.dot.gov.)

The STB has recognized the importance of intraline hauls and network optimization which generate higher ALOH as in, for example, its statement that "[i]t is undisputed within both the railroad and shipping communities that single-carrier service… tends to be more efficient and safer to perform than service involving switching by multiple carriers." (STB Joint Petition for Service Order, No. 1518, February 17, 1998.)

I also have demonstrated and discussed in my research the importance of ALOH as a measure of attained efficiencies from run-through operations. (See, for example, Christopher A. Vellturo, Ernst R. Berndt, Ann F. Friedlaender, Judy Shaw-Er Wang Chiang, and Mark H. Showalter, "Deregulation, Mergers, and Cost Savings in Class I U.S. Railroads, 1974-1986," *Journal of Economics & Management Strategy*, Summer 1992, 1(2): 339-369.) Similarly, Mark Hallman of CN characterized these efficiencies: "'[w]hen we increase the length of haul, we increase the revenue take, we increase the opportunities' to snag yet more business while simultaneously cutting unit costs." (As quoted in Jan Ravensbergen, "CN Gets Its Ticket To The Gulf: Decision Makes It North America's No. 5 Railway," Montreal Gazette, March 26, 1999, p. F1.)

the 1980s also enabled the merged firms to expand run-though operations. This expansion was quite significant, as demonstrated by a 21 percent increase in ALOH for Class I railroads between 1979 and 1989 (595 miles to 723 miles). These run through opportunities were clearly not exhausted in the transactions of the 1980s. ALOH gains have continued to where ALOH in 1998 stood at 835 miles, a 15.5 percent increase over 1989. These increases have largely been concentrated at railroads that have undergone consolidation during the 1990s.[5]

These data reflect a critical strategic repositioning that railroads have undertaken through recent mergers. This repositioning was not a key feature of the merger wave of the 1980s. With increased pressure from a broadly deregulated trucking industry on short hauls, railroad networks have sought to differentiate their product offerings by focusing more intensely on longer-haul, single-line service, where rail has intrinsic cost advantages. The reconfiguration of the rail industry to adapt to this strategic shift has continued up to today, and that reconfiguration, largely through end-to-end mergers, is an essential way to increase ALOH and to respond to new traffic patterns and to create new traffic opportunities. Similarly, recent technological developments (particularly in information technologies) have also provided railroads with new tools with which to reconfigure and utilize their rail systems efficiently.

As a result of all of these changes to the competitiveness of U.S. railroads, average rail freight prices have fallen and output has expanded. For example, the staff of this Board concluded that real rail rates fell by 46.4 percent from 1982 to 1996.[6] Class I rail output has expanded dramatically over this time period. Revenue ton-miles of freight handled by Class I railroads in

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[5] See "Railroad Facts," 1990 through 1999; and Christopher A. Vellturo, Ernst R. Berndt, Ann F. Friedlaender, Judy Shaw-Er Wang Chiang, and Mark H. Showalter, "Deregulation, Mergers, and Cost Savings in Class I U.S. Railroads, 1974-1986," *Journal of Economics & Management Strategy*, Summer 1992, 1(2): 339-369.

[6] See Office of Economics, Environmental Analysis, and Administration, Surface Transportation Board, "Rail Rates Continue Multi-Year Decline," February 1998. The U.S. General Accounting Office also concluded that real rail rates fell (on average) since the passage of the Staggers Act through the period of its analysis, which ended in 1996. (United States General Accounting Office (1999), *Railroad Regulation: Changes in Railroad Rates and Service Quality Since 1990*, GAO/RECD-99-93 at http://www.gao.gov/AIndexFY99/abstracts/rc 99093.htm.)

1978 totaled 858 billion.[7] By 1998, Class I rail freight rose to 1.4 trillion revenue ton-miles, an increase of 63 percent from 1978.[8]

B. Future Considerations

The Board has concluded that "[i]t does not appear that there are significant public interest benefits to be realized from further downsizing or rationalizing of rail route systems, as there is little of that activity left to do."[9] Whether or not this is true, the conclusion does not imply that further merger activity in the rail industry is unlikely to generate significant additional public benefits, as the remainder of the Board's opinion in Ex Parte 582 seems to imply, or that railroads should turn their resources away from mergers and toward infrastructure investment.[10] In fact, the two may be mutually supportive rather than mutually exclusive.

The railroads' continued determination to consolidate further is, in fact, direct evidence not only that additional efficiencies and benefits can be gained through merger, but also that the pursuit of these is a welfare-enhancing use (from a societal perspective) of the financial resources available to the railroads. From the previous section, recall that railroads seek to maximize value to their shareholders, where "value" is measured as the present discounted value of the road's profit stream. It is the fiduciary obligation of each railroad's board to pursue this objective prudently.

How do railroads improve profitability through merger? As alluded to above, railroads can improve profitability through merger in potentially three significant ways: 1) increasing efficiency (lower costs, same output); 2) enhancing utilization (greater output); or 3) increasing market power (higher prices, reduced output).[11] These possibilities are not mutually exclusive. The Board has safeguards firmly in place under its existing approach to rail merger review to ensure that market-

[7] "Railroad Facts," 1986, p. 29.
[8] "Railroad Facts," 1999, p. 27.
[9] As quoted in ANPR, p. 3.
[10] Specifically, "[l]ooking forward, the key problem faced by railroads — how to improve profitability through enhancing the service provided to their customers — is linked to adding to insufficient infrastructure, not to eliminating excess capacity." (As quoted in ANPR, p. 3.)
[11] These possibilities are not mutually exclusive.

power-based profitability is not available to railroads. Railroads continue to seek to merge because they seek to enhance profitability through improved efficiency and greater asset utilization, both of which are welfare-enhancing pursuits to be encouraged by policymakers.

Any proposed railroad combination, by the very fact that the parties involved believe it to be in their financial best interests (accounting for other possible transactions), represents a transaction that dominates alternative transactions involving the merging firms. The simple economic logic that underpins antitrust policy — that, absent an ability of a firm to exercise market power (i.e., restrict industry output), strategic actions by firms will not harm welfare — ensures that alternatives to the proposed transaction and any future transactions that might involve the merging parties, are not expected to generated as large a stream of benefits as the transaction being proposed. For example, a transaction between railroads *A* and *B* may preclude alternative transactions between *A* or *B* and another party. It also may preclude future transactions involving *A/B* and other firms. But, by choosing to merge, *A* and *B* have revealed that their combination produces the greatest benefits (both current and future potential benefits that might arise as a result of future transactions) of potential strategic actions, including alternative combinations. Conversely, if the combination of firm *A* with firm *C* (for example) would generate greater efficiencies (as a direct result of the transaction and in potential future transactions) than a merger of *A* with firm *B*, then firm *A* would undertake such a transaction with firm *C*, not with firm *B*. Thus, mutual agreement by firms *A* and *B* that their merger is the optimal strategic move from a benefits perspective ensures that these firms are engaged in a strategic direction that produces the greatest expected net benefit available using the assets of the two firms.

Critically, railroads have sought to continue to pursue mergers (and incur the associated process and transition expenses) because railroads believe mergers are the *best* (i.e., most efficient) use of their scarce financial resources. A railroad's fiduciary obligation mandates it to evaluate alternatives to merger (including coordination short of merger or internal investment in infrastructure) to determine which investments are likely to lead to the greatest shareholder return. The continued vigor with which railroads seek to pursue mergers is dispositive economic evidence that such investments of the roads' time and energy are welfare-enhancing investments and are to be encouraged.[12]

Indeed, the impetus for further consolidation is clear; railroads continue to seek to reposition their product offerings toward higher quality, longer haul service where railroads have the potential to build the greatest value. This process began in the 1990s and continues to develop, especially with the new opportunities afforded by reduced trade restrictions, particularly within North America.

As a result, the potential for significant welfare gains through rail mergers does not appear to have been exhausted. The source of these gains has changed. What has not changed, however, is that the railroads remain in the best position to evaluate the financial merits of future mergers relative to other investment opportunities, while the Board remains vigilant to ensure that no gains will arise through the exercise of enhanced market power. The fundamental approach that the Board has taken to rail mergers since the passage of the Staggers Act — specifically, the case-by-case evaluation of the potential for the exercise of market power — will continue to serve the public interest.

III. ANALYSIS OF PROPOSED RULEMAKING

With this overriding economic framework as a backdrop, I now consider from an economic perspective specific policy proposals the Board is considering in the present ANPR.[13] I address these issues as they pertain to their place and framework in evaluating rail mergers; indeed, some

[12] Alternatively, one could argue that the railroads are basing their financial decision on faulty or incomplete information and social planners are in a better position to determine appropriate strategic investment decisions for the roads. Given the massive complexity of rail networks and their interaction with each other and other modes of transportation — and the dependence of these judgements on day-in, day-out operation of a railroad and competition with other railroads and other modes — it is highly unlikely that a social planner could gain access to information and analyses or make judgements superior to those of the railroads.

[13] I do not attempt here to address those topics (e.g., the national defense interest in rail consolidations with an international carrier) that may involve a significant noneconomic component in their proposals or effects.

issues may be ripe for evaluation, but tying these issues into the merger review process is unnecessary and potentially socially harmful.

C. Rules to Enhance Competition

The Board stated in the ANPR, "we believe that the time has come to consider whether we should alter our rail merger policy to place a greater emphasis on enhancing, rather than preserving, competition."[14] Several possible mechanisms for enhancing competition are considered by the Board, most of which represent some variant on granting extended access to third parties as a precondition to merger. These variations include outright access grants, interchange regulation, and a reconsideration of the "one-lump" theory for evaluating end-to-end combinations.

At present, rail merger policy directly addresses access issues where the result of the transaction will reduce the number of railroads that have access between given points from two to one; full access is granted to a third-party railroad to maintain extant rail-based rivalry. Similarly, under current policy, the Board has reviewed "three-to-two" effects through "a case-by-case examination based on the individual circumstances of each case."[15] Under the current "one-lump" theory, a merger between a railroad that serves as the sole access to a location and one of several railroads that connect with the sole supplier is presumed not to require an access grant on the solely operated route. This presumption is rebuttable.[16]

It appears as though the access question here addresses whether a merger might present an opportunity to grant or modify access where the proposed merger does not create exclusive access at a given location. To introduce railroads to regulation or remedial action with respect to operations that are not affected in any potentially anticompetitive manner by a proposed transaction would not serve the public interest. The introduction of regulation through the merger process would impose costs on the parties unrelated to the costs and benefits of a proposed combination.

[14] ANPR p. 7.
[15] ANPR, p. 9.
[16] ANPR, p. 8.

The imposition of costs unrelated to a proposed combination would distort the incentives of railroads to undertake welfare-enhancing business combinations and thereby reduce welfare absent the regulation. Also, such an *ad hoc* approach to merger regulation would add significant uncertainty to the merger process, as firms in their evaluations of potential merger benefits (including traffic diversions and utilization studies) would be unable to determine with sufficient certainty the post-merger configuration of their network. Any consideration of competitive access to shippers should take place outside of the merger review process.

In the context of "enhancing competition," the Board also has invited comment on the "one-lump" approach to end-to-end transactions where one of the merging parties has sole access to a given destination, while the other competes with two or more railroads in feeding traffic to and from the sole supplying road. Currently, the Board recognizes (correctly) that the combination of the two firms on an end-to-end basis creates no incremental opportunity for the exercise of market power, and the Board therefore grants a rebuttable presumption that no remedy is required.

As is often the case with "vertical transactions of this nature," the appropriate area of antitrust inquiry (if any exists) is to address vertical foreclosure issues: would the potential denial of access to the captive route impose inefficiencies on the merging firms' rivals along routes where they compete? Such concerns, fortunately, can be tested empirically based on historical conduct. Indeed, it is my present understanding that, since the "one-lump" approach was adopted about 20 years ago, no railroad or shipper has demonstrated the likelihood that a merger would result in any such competitive harm. We would expect this to be the case since the economics of railroad service indicate that success of any attempt by a railroad to foreclose a rival would be unlikely. No competitive limitations appear to require remedial action in "one-lump" situations. Therefore, the Board should not alter its current policy under the "one-lump" theory of granting a rebuttable presumption of no competitive effects of such vertical transactions.

D. Downstream Effects

The Board has proposed to eliminate the "one case at a time" rule under which mergers are evaluated with respect to the net public benefits that the transaction will generate assuming the remainder of the industry will remain at the status quo. Under the revised approach, the Board would examine "the likely 'downstream' effects of a proposed transaction, including the likely strategic responses to that transaction by non-applicant railroads."[17] What is unclear in this proposal is *how* the analysis of the strategic responses of third parties will factor into the consideration of a merger between two parties.

Three possible considerations may arise. First, the Board could attempt to predict the effects of downstream changes on the absolute size of the anticipated net public benefits that the newly merged firm will generate as a result of a proposed transaction. Second, the Board could attempt to predict future industry structure to try to assess the net public benefits of the transaction directly under consideration *and* the structural changes that the current merger will *cause*. Last, the Board could attempt the equivalent of full social planning, where every transaction represents a node at which the net public benefits of all transactions, including direct alternatives to the proposed merger, would be evaluated and weighed to ascertain the "best" combinations. To evaluate the merits of any of these undertakings,[18] one needs to weigh the costs of collecting the information needed for the undertaking against the incremental gain associated with the ability of regulatory oversight to assess more accurately the welfare effects of proposed transactions. I conclude that: (i) the costs of any such information-gathering exercise would be enormous; (ii) the information collected would be of limited quality; and (iii) the undertaking would not enable the Board better to assess the welfare effects of mergers or other combinations for any of the considerations identified above. Therefore, the Board should continue to employ its existing policy and review each proposed combination on its own merits. If it did change its rules, the Board

[17] ANPR, p. 6.
[18] I do not address the separate issue of the legal authority of the Board to undertake these evaluations.

would impose substantial external costs on proposed combinations and increase the risk of denying combinations that enhance social welfare (with no concomitant reduction in the risk of approving combinations that reduce social welfare).

1. Predicting Future Industry Structure to Assess the Absolute Nature of the Anticipated Net Benefits of the Proposed Transaction

When evaluating the likelihood and magnitude of the proposed synergies and efficiencies that a specific transaction might generate, the Board might undertake an assessment of the effects of future industry structure and future competition on the anticipated net benefits of the proposed transaction. Under this approach, the assessment of the likely strategic responses of other firms would be considered probative in assessing the welfare effects of a proposed transaction.

What net benefits could the Board anticipate from undertaking such an analysis? The costs of such an undertaking are obvious. Yet the quality of information from this undertaking would be potentially limited. These data would need to provide extensive traffic projections, operating plans and cost synergies, and investment strategies for mergers that have not only have yet to be announced; they have yet to be even *contemplated* by the parties potentially involved. Firms that are directly involved in the merger process hire consultants and dedicate significant internal resources to studying these issues. The likelihood that firms not even contemplating a transaction would dedicate the resources and time necessary to produce reliable forecasts for the Board to utilize effectively in evaluating an antecedent transaction seems quite remote. This may be particularly true if the transaction under review is one that may intensify competition for the parties from whom the Board seeks information.[19] In the case of other announced transactions, the parties

[19] Indeed, the information may be the product of firm opportunism. For example, such a burden on "first in" mergers would create perverse incentives for other railroads to imply that inefficient future transactions will ensue as a result of the first merger. Competitors and other third parties would seek to stave off the increased competitive vigor that the first merged firms might exact on them. As a result, the regulatory burden would not just impose additional costs on the first applicants, but could harm the public as well by denying the public access to more vigorous competition. The hypothetical nature of the whole inquiry would mean that parties interested in blocking a transaction would have both the incentive and ability to distort the information they provide to the Board. And, unlike under the existing review process, the merging parties would find it difficult to dispute such submissions as the submissions necessarily would rely on the stated (but unverifiable) intents of

to those announced transactions will be the best sources of information on the characteristics of their transaction, e.g., as the operating plan (which would be a prerequisite for the analysis of the effects of one transaction on another). But, the delay in accessing that information may be significant and other transactions may be announced in that delay (raising the question of when the analysis is complete and creating opportunities for hold-up by competitors, all with little countervailing public benefit and significant costs from the delay of welfare-enhancing combinations).

Even if the Board could collect high quality information on downstream transactions at little cost, the Board's analysis of such data would not add incrementally to the assessment of the welfare effects of a proposed transaction. This would not be from any analytic shortcoming on the Board's part. It would stem simply from the fact that the merging parties, motivated by private incentives, already would have undertaken such an exercise, either explicitly or implicitly, with the best information available to them.[20]

Thus, for example, when the managements of railroads *A* and *B* are evaluating whether to merge with each other, they have the incentives to consider, at implicitly, whether they will be competing with a railroad formed by the merger of firms *C* and *D*, or with these railroads as independents. *A/B* would have private incentives to assess the probabilities that it would be able to realize the benefits of its merger; these benefits are its only possibilities for increasing its profits since the Board would foreclose an opportunity to accrue market power. The moving parties (*A* and *B*) may, for example, anticipate traffic diversions as a result of their transaction which would be reduced if *C* and *D* merge and offer their own improved transportation services.[21] It bears mention that such an outcome of a *C/D* merger implies that the better products or cheaper prices

the parties to act in the future.

[20] The effort of merging parties to assess these effects does not imply that it may be possible to demonstrate these assessments before the Board. The consideration may be implicit rather than explicit, it may rely on the experience of executives about the conduct of competitors, etc.

[21] Even if *A/B* recognizes that some of its gains may be short lived, it may still undertake a transaction in order to reduce the diversion of traffic to a merged C/D if it does not.

offered by the merged *A/B* were matched by *C/D*, an outcome that public policy should favor since welfare must be higher from the increased competition.

2. Predicting Future Industry Structure to Assess the Net Benefits of the Current and Future Transactions

Alternatively, the Board could evaluate a proposed business combination on the basis of the aggregate net benefits of the proposed combination and the net benefits of any future mergers that might arise as a consequence of the transaction under review. This approach also places an unnecessary burden on the parties that move first and could lead the Board to restrict welfare-enhancing combinations. It shares with the proposal discussed above the large private and public costs of information gathering and the incentive problems for truthful and complete revelation of nonverifiable information by interested parties. The costs only would be higher as the parties attempt to document the merits and costs of downstream transactions. As above, such a regulatory approach also would place unnecessary burdens on this Board (and the parties to a proposed combination) to engage in a highly speculative and expensive effort of predicting welfare consequences of multiple merger permutations in the (potentially distant) future.

A number of other factors indicate that such an undertaking would be in opposition to the public interest. First, the Board need not consider the effects of downstream mergers as a cost to the current merger. If a merger that generates net benefits (regardless of future industry structure) is likely to lead to a second merger between firms that will not serve the public interest, the Board can clearly act — at the time of the second merger — to preserve the public interest. This way, the net public benefits of the first transaction are retained. Second, the parties and the Board would need to determine causality, i.e., to identify which "downstream" transactions would occur *only* if the proposed merger is consummated and which downstream transactions would be hastened or delayed by the proposed transaction. Such an undertaking would be virtually impossible and would require the detailed revelation by competing railroads of their most strategic competitive information.

3. Predicting Future Industry Structure to Assess the Comparative Benefits of Potential Merger Scenarios

Finally, the Board could undertake an evaluation of *all* potential permutations of business combinations — including those that might arise if the first-in combination were not allowed — to determine which possible combinations would maximize welfare. In theory, this approach would seek to nullify a first-in merger that forced subsequent suboptimal consolidations in some future round. Note that this exercise is particularly worrisome since the first-in merger represents a transaction that must generate the greatest mutual benefit (here efficiencies) for the merging parties when compared to any other transaction because the parties agreed to their transaction over all other available alternatives.[22]

Under this approach, the Board would be required, in effect, to evaluate accurately all possible merger permutations and their net public benefits and then to prescribe the final structure of the North American rail industry, at the time of the first-in merger application. Such an undertaking would be of enormous complexity and would cast the Board in the role of a pure social planner. Additionally, the process would again place third parties in a position where they could seek to "game" the regulatory system to achieve firm-optimal, though socially suboptimal, outcomes.[23]

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[22] In an extreme and oversimplified model, assume only four railroads exist. *A* proposes to merge with *B* and generate benefits of $100 million. *C* then merges with *D* and generates $10 million. In the alternative, *C* merges with *A* and generates $60 million, while *D* merges with *B* and generates $60 million as well. Under the proposed approach, the Board would deny the *A/B* merger, in effect leaving as the only option the *A/C* and *B/D* combinations, since the aggregate benefits under *A/C-B/D* ($120 million) exceed those under *A/B-C/D* ($110 million).

[23] In order to consider the firm-optimal but socially suboptimal outcomes, return to the previous example with the assumptions that *A/B* will again generate $100 million, and *C/D* will generate $10 million. Now assume that *A/C* will generate $20 million, and *B/D* will generate $20 million. Now the *A/C-B/D* sequence offers $40 million in public welfare, while the *A/B-C/D* combination is far superior at $110 million. Yet, in this situation, both *C* and *D* would attempt to block a proposed *A/B* combination. Needless to say, if *C* attempted to acquire *A*, *A* would not agree; an attempt by *D* to pursue *B* would yield the same result.

Social planning exercises, such as those proposed in the second and third scenarios above, are fraught with enormous informational burdens and potentials for opportunism and are of no or dubious benefit for evaluating the welfare effects of a proposed transaction. The first proposal is duplicative of undertakings by the parties to the proposed tr. nsaction. For these reasons, it is in the public interest that the Board continue its current policies of evaluating mergers on a case-by-case basis and on their own merits.

E. Promoting and Enhancing Service During Implementation

Recently, shippers have vociferously stated their concerns regarding the negative impacts that post-merger difficulties of some recent combinations have had on service quality during implementation at the combined roads. The Board has proposed that, as part of the merger process, it will seek to evaluate how these costs can be reduced or, at a minimum, how shippers' burden of these costs can be reduced. Service guarantees by merging railroads provide an economically rational and effective means by which to reduce these shipper-borne costs and risks. Under a service guarantee, railroads would have the incentives to account for the burdens of service difficulties on shippers and, therefore, to act to offset these through improved merger implementation.

Recent post-merger difficulties have generated significant added costs and revenue shortfalls at the constituent railroads during implementation. These difficulties also have generated higher costs and service problems among shippers. As I understand the Board's current merger review process, railroads have not been required to bear (i.e., "internalize") any of the indirect costs that a proposed combination may impose on shippers (a transitional "externality").[24] The economic problem that may develop as a result of this externality is that railroads may fail to consider the full social costs of transitional service difficulties. In general, to ensure the devotion by railroads of additional resources to resolve transitional service difficulties, railroads should bear some, though

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[24] Railroads do bear the concomitant loss of revenues and business goodwill from service difficulties.

not necessarily all, of the external costs that asset combinations and system rationalizations may impose on shippers.[25]

Service guarantees between railroads and shippers help to "internalize" the cost externalities that sometimes can be imposed on shippers as part of the railroad merger process. Guarantees thereby help to ensure a socially preferable transition. With service guarantees, the combining railroads assure that certain performance standards will be maintained throughout the merger transition process. For example, if the assurances are not met, the railroads might face financial costs (beyond the direct costs incurred through higher internal costs and reduced revenues at the roads). This stake in the continued efficient provision of transportation services to their customers throughout the transition phase provides significant incentives for the railroads to minimize transitional issues and, thereby, the concomitant hardship to shippers. Such an approach, from an economic standpoint, provides significant redress for addressing shippers' concerns in this area.

This analysis assumes that railroads and shippers can agree on performance standards and financial incentives for service during implementation. If railroads and shippers fail to reach agreements, then, since no "one size fits all" agreement would be appropriate, the Board is faced with a number of possible mechanisms for addressing possible future service difficulties. For example, the Board could consider employing an efficient dispute resolution process such as the arbitration mechanism I understand the Board currently employs to resolve differences in labor agreements between combining railroads and their unions. This would place the Board in the position of arbiter of last resort in the event of an impasse.

F. "Three-To-Two" Issues

[25] The goal is to devote the socially optimal level of resources to avoiding and rectifying service difficulties. This is not necessarily equivalent to guaranteeing existing service; the goal of policy should not necessarily be to provide insurance for existing service levels. Shippers may need to retain appropriate incentives to utilize new service patterns, and to take on potential risks to realize gains through reconfigurations.

The Board is seeking comment on whether its historic, case-by-case approach to assessing the competitive impact in "three-to-two" situations should be reconsidered. From an economic standpoint, the logic of a case-by-case approach to such competitive issues is sound and has been reinforced by recent developments. The Board should continue to employ a case-by-case approach in future transactions.

The existing record on the merits of a case-by-case approach to "three-to-two" issues is extensive, and I do not review it here. A presumptive finding of competitive harm in "three-to-two" corridors or at "three-to-two" shippers with respect to rail transportation is ill advised, given the vastly complex arena within which railroads interact and compete.[26] For example, industry characteristics such as cost structure; characteristics of transportation products and services such as heterogeneity; characteristics of transactions such as secrecy of service contracts; as well as intermodal competition and source/destination-based competition, are just a few of the factors that may have a material bearing on the likely competitive effects of a "three-to-two" combination (or any structural change in the number of rail participants). Given the nature of these factors, a fact-intensive review of "three-to-two" issues is warranted.

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[26] Jonathan Baker, then Director of the Bureau of Economics of the Federal Trade Commission has described the evolution of antitrust, including merger review, toward a case-by-case, fact-oriented undertaking:

> Three decades ago, antitrust law relied heavily upon "per se" rules, which took the broad brush approach of deeming certain classes of business practices anticompetitive without regard to their effects in any particular case. Today, a case-by-case analysis is more common, often under the judicial rubric of applying the "rule of reason"... A benefit of this trend toward a more detailed economic analysis of individual practices is that it can reduce errors in determining the likely effects of business conduct.

(Jonathan B. Baker, "Policy Watch: Developments in Antitrust Economics," *Journal of Economic Perspectives*, Winter 1999, 13(1): 181-94.) See also William E. Kovacic and Carl Shapiro, "Antitrust Policy: A Century of Economic and Legal Thinking," *The Journal of Economic Perspectives*, Winter 2000, 14(1): 43-60.

This approach is reflected in the *Merger Guidelines* employed by the Department of Justice and the Federal Trade Commission in evaluating the likely competitive effects of business combinations. (Specifically, the agencies concluded that "it is not possible to remove the exercise of judgment from the evaluation of mergers under the antitrust laws... [and] [t]herefore, the Agency will apply the standards of the Guidelines reasonably and flexibly to the particular facts and circumstances of each proposed merger". *Horizontal Merger Guidelines*, Department of Justice Antitrust Division and the Federal Trade Commission, 1992, Section 0.)

The need for a fact-specific approach to these issues has only intensified with the increased globalization of the U.S. and other economies. Particularly, source-and-destination based opportunities for products transported by North American railroads have expanded markedly as a result of trade liberalization in the U.S. and abroad, bringing new sources of competitive discipline. These increased opportunities place greater pressure on railroads to compete for traffic. The intensity of these constraints can be expected to vary, both by product and locale, and again must be evaluated case by case.

G. Evaluating Mergers vis-a-vis Alternative Contractual Arrangements

The Board is considering whether to require merging railroads to demonstrate that any claimed public benefits or synergies related to their proposed transaction are not achievable short of merger. Such a restriction is, first, too broad and difficult to implement and, second, unnecessary as a matter of economics.

Placing the burden on the merging parties of demonstrating that no other means exist by which the proposed merger-related benefits and synergies can be achieved represents a standard that is far too broad and costly. If taken literally, this standard implies that any synergy that potentially can be implemented through any non-merger means, regardless of cost, will be ignored. Such an approach can obviously lead to serious policy mistakes that lower public welfare. If the standard is taken less restrictively, the parties will be required to demonstrate (and the Board to evaluate) the cost-benefit trade-offs of a vastly complex series of hypothetical, potential joint ventures, VCAs, long-term contracts, and/or access agreements. The evidentiary and time burdens associated with this analysis on the parties and the Board would be immense and, once again, would be subject to potential opportunism by competitors and other third parties seeking to delay or dampen the procompetitive impacts of a business combination.

More importantly, the investigation and analyses of the potential for more efficient, nonmerger means to achieve the proposed efficiencies and synergies serve no useful policy purpose, as the "market mechanism" discussed above already ensures that the most efficient use of the merging parties' resources is embodied in the proposed merger. If any other combination or contractual provision, including a VCA, long term contract, or joint marketing agreement, were a more efficient mechanism by which the parties could achieve additional cost savings or service/output enhancements than the proposed merger, then those alternatives would have been chosen by the merging parties as the more financially responsible use of their firms' scarce resources.

H. "Too Big To Manage, Too Big To Fail"

Finally, the Board has noted the concerns that "big" may be inherently "bad" and that, as raised by Secretary Slater of the Department of Transportation, continued rail consolidation will create railroads that are "too big to manage, yet too big to fail."[27] Underlying this concern is a generalized economic notions that (i) these large rail systems will have exhausted scale economies and moved into the decreasing returns to scale portion the industry cost curve ("too big to manage"); and (ii) these large rail systems present the potential for serious harm to various markets within the U.S. economy if the firms were to face financial disaster ("too big to fail").

A detailed economic analysis reveals, however, that mergers will continue to afford opportunities for a more efficient network structure in the face of rising competition from other modes and from overseas imports and will reduce the likelihood that any given railroad will face financial disaster. The new systems will be "big enough to compete, stable enough to take the heat." Greater efficiencies reduce the likelihood of failure while increasing efficencies that are particularly important in the face of increasing overseas and other competition.

The potential for future mergers to offer improved run-through operations and more efficient and more effective long hauls was detailed earlier in this paper. The ability of North American railroads to implement this business plan is particularly important, as the railroads seek to differentiate their product offerings in the face of ever increasing competition in the short-to-

[27] Secretary Slater, U.S. Department of Transportation, as quoted at ANPR p. 7.

medium haul arena from other modes, most notably trucks. The realization of these length of haul possibilities (and the reconfiguration of the rail system to best take adva....ge of these efficiencies) may well be critical to the long-run viability of the North American rail system.

Furthermore, consolidation of the North American rail system enables the new railroad systems to diversify their production portfolio, thereby reducing their reliance on a single (or smaller) set of industries.[28] With a broader range of industries served, the railroads may be better able to survive a significant transitory downturn in a given industry (e.g., automobile manufacturing), or may have the ability to reconfigure their networks in response to the longer term loss of business due to increased competition through the global economy (e.g., paper and forest products) or in response to changing trade patterns that present new opportunities for rail tra... ortation.

IV. SUMMARY

The existing merger review infrastructure has served the public well. A fundamental restructuring of the U.S. rail industry has been undertaken with minimal regulatory intervention and cost, and pro-competitive and highly efficient outcomes. While the environment in which railroads operate and compete has undergone change during this era, the fundamental paradigm of merger implementation — railroad-identified merger opportunities tempered with preemptive antitrust intervention by the Board to prevent the accrual of market power — will continue to provide an effective means with which to evaluate proposed transactions and implement approved, welfare-enhancing ones. A fact-specific inquiry with respect to issues specific to the merger's

[28] For example, according to Canadian National Railway ("CN"), if CN and Burlington Northern Santa Fe ("BNSF") were permitted to consummate their proposed combination, the resulting railroad would rely on no traffic category for more than 35 percent of its traffic mix. In contrast, merchandise now accounts for 50 percent of CN's traffic. The combination would rely proportionally less than BNSF now does on coal and intermodal/automotive traffic while, of course, carrying increased volumes of each. (See, e.g., http://www.cn-bnsfcombination.com/eng/speeches/NARIpres.pdf.)

direct impact on efficiency and competition has been the hallmark of the Board's approach to the public benefit standard it seeks to enforce. This effective paradigm should largely be maintained. Additional merger-related assurances through service guarantees may be in order as an effective means by which to increase railroads' incentives to account properly for the potential harm transitional service difficulties may impose on shippers' economic interests. Otherwise, the merger review process of the Board is well equipped to manage and enable effectively any future welfare-enhancing transactions that the railroads put forward.

CHRISTOPHER A. VELLTURO

Analysis Group/Economics

One Brattle Square

Fourth Floor

Cambridge, Massachusetts 02138

(617) 349-2143

cvellturo@analysisgroup.com

Dr. Vellturo, a Principal of Analysis Group/Economics, has performed economic analysis and provided expert testimony in the context of mergers and acquisitions, antitrust litigation, intellectual property litigation, and other matters. He has provided economic analysis in over one hundred mergers and acquisitions spanning a broad array of industries. He has appeared before the U.S. Department of Justice, the Federal Trade Commission, various states' Attorneys General offices, the Federal Reserve Bank Board of Governors, and various Federal Reserve Banks on merger-related issues. He has also appeared at hearings before the European Commission. Dr. Vellturo has performed economic analysis relating to litigation matters in more than twenty-five antitrust actions and more than one hundred intellectual property actions. He has testified in U.S. District Court and before the American Arbitration Association.

Dr. Vellturo has published on issues relating to merger and acquisition related efficiencies, price discrimination, and market definition, among other topics. His writings have appeared in *Antitrust*, the *Antitrust Law Journal*, the *Journal of Economics and Management Strategy*, and the *Journal of Productivity Analysis*, among others.

Dr. Vellturo received a Sc.B. degree in Applied Mathematics/Economics *magna cum laude* from Brown University in Providence, Rhode Island. He earned a Ph.D. in Economics at Massachusetts Institute of Technology (MIT), specializing in Industrial Organization and Econometrics.

EDUCATION:

MASSACHUSETTS INSTITUTE OF TECHNOLOGY
Ph.D., Economics, 1989

Primary Fields: Econometrics, Industrial Organization
Secondary Fields: Public Finance, Game Theory, Law and Economics

BROWN UNIVERSITY
Sc.B., Applied Mathematics and Economics (*magna cum laude*), 1983

PROFESSIONAL EXPERIENCE:

2000-Present ANALYSIS GROUP/ECONOMICS
Principal. Direct research and provide expert testimony on a variety of microeconomic issues with particular emphasis on antitrust, intellectual property, and mergers and acquisitions. Expert reports and testimony presented in U.S. District Court. Presented antitrust economic analyses to Federal Trade Commission, U.S. Department of Justice, Federal Reserve Bank Board of Governors and the European Commission.

1999-2000 NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.
Senior Vice President.

1996-1999 NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.
Vice President.

1991-1996 CAMBRIDGE ECONOMICS, INC.
Director. Directed research and provided expert testimony on a variety of microeconomic issues with particular emphasis on antitrust, intellectual property, and mergers and acquisitions. Prior expert testimony provided in U.S. District Court and before the American Arbitration Association. Presented antitrust economic analyses to U.S. Department of Justice, Federal Trade Commission (Antitrust Division), state Attorneys General offices, and the Federal Reserve Bank Board of Governors.

1989-1991 NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.
Senior Consultant. Directed and performed research relating to issues of antitrust, intellectual property, mergers and regulation.

1987 DEPARTMENT OF ECONOMICS, M.I.T.
Teaching Assistant. Undergraduate econometrics.

1985-89 DEAN ANN F. FRIEDLAENDER, M.I.T.
Research Associate. Participated in research relating to transportation pricing and capital allocation responses to regulatory changes.

1983-85 NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.
Research Associate. Conducted research on a wide variety of issues including antitrust, railroad rate setting, optimal landfill pricing, and PCB and asbestos abatement strategies.

AWARDS AND PROFESSIONAL ACTIVITIES:

Recipient, Bradley Fellowship in Public Economics, 1987 and 1988-89

M.I.T. Departmental Fellowship, 1986

Phi Beta Kappa, Brown University, 1983

Sigma Xi, Brown University, 1983

Journal Referee for *American Economic Review* and *Rand Journal of Economics*

Member, American Economic Association

PUBLICATIONS AND PRESENTATIONS:

"What Drives Consolidation?" Presented at the 28th Semiannual Members Meeting MIT/CRE, Cambridge, MA, May 14, 1998.

"Proving Unilateral Effects and Efficiencies in Merger Cases: A Demonstration." Presented at the 46th Annual ABA Antitrust Meeting, Washington, DC, April 1, 1998.

"Creating An Effective Diversion: Evaluating Mergers With Differentiated Products," Antitrust, Spring 1997.

"Economic Battles in the Antitrust Wars: Network Industries and Their Relevance to Antitrust in the Computer Industry." Presented at the Washington State Bar Association's Thirteenth Annual Antitrust, Consumer Protection and Unfair Business Practices Conference, November 8, 1996.

"Differentiated Products: New Tools for New Methods." Presented at NERA's Seventeenth Annual Antitrust & Trade Regulation Seminar, Santa Fe, NM, July 5, 1996.

"Market Definition Under Price Discrimination" (with J. A. Hausman and G. K. Leonard), Antitrust Law Journal, Vol. 64, No. 2 (Winter 1996).

"Learning-by-Doing in the Context of Antitrust Analysis" (with J. Hausman), April 1995.

"An Economic Analysis of ATM Surcharging," prepared for Southeast Switch Inc., October 5, 1995.

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"Deregulation, Mergers and Cost Savings in Class I U.S. Railroads, 1974-1986" (with Berndt et al.), Journal of Economics and Management Strategy, Vol. 1, No. 2, 1992.

"Observations on Pre-Trial Bargaining Models," MIT Mimeo, September 1989.

"The Deregulation of the U.S. Rail Industry: Efficiency and Equity in Attaining Rail Viability," Ph.D. Dissertation, Department of Economics, MIT, 1989.

"Achieving Cost Efficiency Through Merger: Evidence from the U.S. Rail Industry," Presented at the American Economic Association Symposium on Mergers and Acquisitions, New York, December 29, 1988.

PREVIOUS COURT TESTIMONY (PAST FOUR YEARS):

Sulzer Intermedics, Inc. v. Medtronics, Inc., et al (U.S. District Court, Southern District of Texas, (C.A. H-97-3526)).

Joseph E. Seagram & Sons, Inc., The Seagram Company Ltd. and JDC S.A. de C.V. v. St Maarten Spirits, Ltd., and St. Maarten Spirits Limited (Superior Court of the State of California, for the County of Los Angeles, (No. BC 191 681)).

General Electric Capital Corporation v. DirecTV, Inc., Hughes Electronics Corporation and General Motors Corporation (U.S. District Court, District of Connecticut, 3:97 CV 01901 (PCD)).

Bristol Technology, Inc. v. Microsoft Corporation, (U.S. District Court, District of Connecticut, C.A. No. 398-CV-1657 (JCH)).

America Online, Inc. v. AT&T Corporation, (U.S. District Court, Eastern District of Virginia, C.A. No. 98-1821-A).

Forty-Niners Truck Plaza, Inc. v. Unocal Corporation, (Superior Court in and for the County of Sacramento, California, Case No. 531830).

Dade Behring Marburg Gmbh, Syva Company v. Biosite Diagnostics, Inc.,(U.S. District Court, Southern District of New York, C.A. No. 97-501 MMS).

CBS Broadcasting Inc., et al., v. PrimeTime 24 Joint Venture, (U.S. District Court, Southern District of Florida, C.A. No. 96-3650-CIV-Nesbitt).

Becton Dickinson and Company v. Syntron Bioresearch, Inc. (U.S. District Court, Southern District of California, C.A. No. 97-CV-1634K (POR)'

Hard Rock Café International (USA), Inc., (f/k/a Rank Licensing, Inc.), v. Peter A. Morton and Hard Rock Hotel, Inc. (U.S. District Court, Southern District of New York, C.A. No. 97-CIV-9483 (RPP)).

Wang Laboratories, Inc. v. FileNet Corporation (U.S. District Court, District of Massachusetts, C.A. No. 94-12141).

Neles-Jamesbury, Inc. v. Fisher Controls International, Inc. and Fisher Service Company (U.S. District Court, District of Massachusetts, C.A. No. 94-40200).

The Toro Company v. White Consolidated Industries, Inc. and WCI Outdoor Products, Inc. (U.S. District Court, District of Minnesota, C.A. No. 4-95-656).

Polo Ralph Lauren, L.P.. v. The Magnin Company, Inc. (American Arbitration Association Commercial Arbitration Tribunal, Case No. 74-181-1094-96).

Roll Systems, Inc. v. Wallace Computer Services Inc. (U.S. District Court, District of Massachusetts, C.A. No. 94-10372-MEL).

Black & Decker (U.S.), Inc. and Black & Decker, Inc. v. The Coleman Co., Inc. (U.S. District Court, Eastern District of Virginia, C.A. No. 96-656-A).

Century Wrecker Corporation v. Chevron, Inc. (U.S. District Court, Western District of Pennsylvania, C.A. No. 89-1452).

Federal Trade Commission v. New Balance Athletic Shoe, Inc. (Boston, Massachusetts, File No. D9268).

Minnesota Mining and Manufacturing Co. v. Avery Dennison Corp. (U.S. District Court, District of Minnesota, C.A. No. 4-93-1070).

Becton Dickinson and Co. and Becton Dickinson Vascular Access Inc. v. Critikon Inc. (American Arbitration Association, Arbitration No. 13 133 00388 93).

Minnesota Mining and Manufacturing Co. v. Norton v. Bay State Abrasives Co. (U.S. District Court, District of Delaware, C.A. No. 89-533 (JJF)).

AFFIDAVITS

Expert Report in connection with *Omniglow Corporation v. Unique Industries, Inc.*(U.S. District Court, District of Massachusetts, (C.A.No. 99-30052-MAP)), November 1999.

Expert Report in connection with Joseph *E. Seagram & Sons, Inc., The Seagram Company Ltd. and JDC S.A. de C.V. v. St Maarten Spirits, Ltd., and St. Maarten Spirits Limited* (Superior Court of the State of California, for the County of Los Angeles, (No. BC 191 681)), August 1999.

Expert Report in connection with *General Electric Capital Corporation v. DirecTV, Inc., Hughes Electronics Corporation and General Motors Corporation* (U.S. District Court, District of Connecticut, 3:97 CV 01901 (PCD)), August 1999.

Expert Report in connection with *America Online, Inc. v. AT&T Corporation* (U.S. District Court, Eastern District of Virginia, C.A. 98-1821-A), March 1999.

Expert Report in connection with *Ashraf M. Dahod v. Bay Networks, Inc. and LanCity Corporation, Inc.* (U.S. District Court, District of Massachusetts, C.A. No. 96-11907 REK), September 1998.

Expert Report in connection with *Harris Corporation, et. al v. Atmel Corporation,* (U.S. District Court, Eastern District of Virginia, C.A. No. 98-98-A), June 1998.

Expert Report in connection with *Critikon, Inc. v. Becton Dickinson Vascular Access, Inc.,* (U.S. District Court, District of Delaware, C.A. No. 93-108 (JJF)), June 1998.

Expert Report in connection with *CBS Broadcasting Inc., et al., v. PrimeTime 24 Joint Venture,* (U.S. District Court, Southern District of Florida, C.A. No. 96-3650-CIV-Nesbitt), May 1998.

Expert Report in connection with *Becton Dickinson and Company v. Syntron BioResearch, Inc.* (U.S. District Court, Southern District of California, C.A. No. 97-CV-1634K), May 1998.

Expert Report in connection with *Luigino's, Inc. v. Pezrow Company, Inc. and Pezrow Company of New Jersey, Inc.* (U.S. District Court, District of Minnesota Fifth Division, C.A. No. 5-96-244), October 1997.

Supplemental Expert Report in connection with *Neles-Jamesbury, Inc. v. Fisher Controls International, Inc. and Fisher Service Company* (U.S. District Court, District of Massachusetts, C.A. No. 94-40200), October 1997.

Expert Report in connection with *Neles-Jamesbury, Inc. v. Fisher Controls International, Inc. and Fisher Service Company* (U.S. District Court, District of Massachusetts, C.A. No. 94-40200), August 1997.

Expert Report in connection with *The Toro Company v. White Consolidated Industries, Inc. et al.* (U.S. District Court, District of Minnesota, C.A. No. 4-95-656), May 1997.

Supplemental Expert Report in connection with *Century Wrecker Corporation v. Chevron, Inc.* (U.S. District Court, Western District of Pennsylvania, C.A. No. 89-1452,), May 1997.

Supplemental Rebuttal Expert Report in connection with *Polo Ralph Lauren, L.P.. v. The Magnin Company, Inc.* (American Arbitration Association Commercial Arbitration Tribunal, C.A. No. 74-181-1094-96), May 1997.

Rebuttal Expert Report in connection with *Polo Ralph Lauren, L.P.. v. The Magnin Company, Inc.* (American Arbitration Association Commercial Arbitration Tribunal, C.A. No. 74-181-1094-96,), May 1997.

Expert Report in connection with *Wang Laboratories, Inc. v. FileNet Corporation.* (U.S. District Court, District of Massachusetts, C.A. No. 94-12141 RLC), April 1997.

Affidavit in Support of Ag-Chem Equipment Co. Inc. and Soil Teq, Inc.'s Motion For Summary Judgment. (U.S. District Court, District of Minnesota, C.A. No. 4-93-1228), August 1996.

Expert Report and Supplemental Expert Report in connection with *Roll Systems, Inc. v. Wallace Computer Services Inc.* (U.S. District Court, District of Massachusetts, C.A. No. 94-10372-MEL,), July 1996 and December 1996.

Expert Report in connection with *Dynamic Manufacturing Inc. et al. v. Chevron Inc.* (U.S. District Court, Eastern District of Virginia, C.A. No. 2:95CV947), April 1996.

Expert Report in connection with *Century Wrecker Corp. v. Chevron Inc.* (U.S. District Court, Western District of Pennsylvania, C.A. No. 89-1452), March 1996.

Expert Report in connection with *Medtronic v. Pacesetter and St. Jude Medical Inc.* (American Arbitration Association), February 1996.

Expert Report in connection with *Cedar Ridge Trailer Sales et al. v. National Community Bank of New Jersey et al.* (Superior Court of New Jersey , C.A. No. BER-L-09277-92), December 1995.

Expert Report in connection with *Federal Trade Commission v. New Balance Athletic Shoe, Inc.* (Boston, Massachusetts, File No. D9268), 1995.

Expert Report in connection with *Minnesota Mining and Manufacturing Co. v. Avery Dennison Corp.* (U.S. District Court, District of Minnesota, C.A. No. 4-93-1070), 1995.

Expert Report in connection with *Minnesota Mining and Manufacturing Co. v. Norton v. Bay State Abrasives Co.* (U.S. District Court, District of Delaware, C.A. No. 89-533 (JJF)), 1994.

INDUSTRY EXPERIENCE:

- Textiles
- Over-the-Counter Drugs
- Toiletries
- Lighting Products
- Paper
- Retail Stores
- Software & Operating Systems
- Banking/EFT Networks (ATM/POS networks, Thrifts; Transfer Services)
- Cable Television Services
- Glassware
- Seafood
- Produce
- Breakfast Cereals
- Footwear
- Diapers
- Cigarettes
- Car Wax
- Personal Computers
- Contact Lens Care Products
- Prescription Drugs
- Spinal Implants
- Angioplasty Catheters
- Intravascular Ultrasound
- Infusion Pumps
- Pacemakers and Defibrillators
- Prescription Benefits Services
- PTCA Catheters
- Fiberglass Casting Products
- Catheter Dressings, Catheters
- Hemodialysis Catheters (Mahurkar)
- Home Pregnancy Testing Kits and Related Technologies
- Magnetic Resonance Imaging (MRI) Devices and Contrast Agents
- Diabetes Testing Devices
- Legal/Financial Publications and CD ROM Titles
- Domestic and Commercial Circuit Breakers
- Heating, Ventilation, and Air Conditioning (HVAC) Systems
- Check Verification Services; Credit Card Processing Services, EFT Product Services
- Industrial Cleaning Products and Services
- Printing
- Paperboard
- Aluminas and Related Compounds
- Manmade Fibers (Nylon and Polyester)
- Fertilizer
- Cable Services and Programming; Entertainment; Sports Programming
- Printed Circuit Board Assembly Equipment
- Food Metal Cans
- Flight Simulators
- Airlines
- Airline Computer Reservation Systems
- Microprocessors/DRAMs/EPROMs
- Fertilizer Equipment
- Wholesale Financing Services – Motor Homes
- Natural Gas
- Photocopiers
- Telecommunications Equipment and Services
- Precision Weighing and Measuring Instruments

- Single Inline Memory Modules (SIMMS)
- Metal Can Interior Coatings
- Gypsum Board
- Industrial Grinding Products
- Flexographic Printing Plates
- Facsimile Machines
- Chemiluminescent Technologies
- Photography Products
- Automotive Products
- Industrial Diamonds
- Cosmetics
- Dental Implants
- Waste Disposal and Collection Services
- Liquor
- Salt
- Sugar
- Cable and Satellite Television Products and Services
- Network Systems
- Railroad Equipment and Services
- Commercial Laboratory Services
- Educational Publishing
- Exploration Oil and Production Services
- Car Carriers and Wreckers
- Cellular Telephones
- Flashlights
- High Speed Printing and Processing Equipment
- Data Collection and Related Applications Technologies
- Toys
- Retail Garments and Accessories
- Industrial Valves
- Lawn and Garden Equipment
- Continuous Blood Pressure Monitoring Devices
-

January 2000

VERIFICATION

I, Christopher A Vellturo, verify under penalty of perjury under the laws of the United States that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on May 16, 2000.

Christopher A. Vellturo

CERTIFICATE OF SERVICE

I certify that I have this 16th day of May, 2000, served copies of the foregoing Comments of Canadian National Railway Company (including the attached Statement of Christopher A. Vellturo, Ph.D.) upon all known parties of record in this proceeding by first-class mail or a more expeditious method of delivery.

Sülay Öztürk